THE QUARTERLY JOURNAL OF AUSTRIAN ECONOMICS

SPRING 2002 · VOLUME 5, NUMBER 1

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Rutgers—The State University of New Jersey
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The Quarterly Journal of Austrian Economics

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CAN AGENCY THEORY JUSTIFY THE REGULATION OF INSIDER TRADING?

ALEXANDRE PADILLA

Insider trading occurs if an insider uses material, nonpublic information about a corporation in a securities trade.[1] This sort of activity is generally prohibited by securities regulation. Its prohibition has been the subject of an important debate since the 1960s.

One of the most famous arguments against the prohibition of this kind of behavior is that insider trading represents the most appropriate compensation scheme to reward the entrepreneurial activity of insiders. Consequently, we should expect that some corporations will allow their insiders to use inside information in order to stimulate their entrepreneurial and innovative activity (Manne 1966).

This argument has been strongly challenged. Some argue that letting firms allow their insiders to trade on inside information gives rise to agency problems that shareholders would be unable to resolve. No firm should be authorized to allow insider trading because shareholders are not able to control the activity of their insiders (Easterbrook 1981 and 1985). This is closely related to the Berle and Means argument that modern corporations are characterized by the separation of ownership and control. In other words, the owners have lost the control of the corporation and are unable to control the activity of the management (Berle and Means 1932).

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[1]It is necessary to clarify that, even if the legislation and, in particular, United States legislation, has a different definition of an insider, most of the literature generally defines an insider as an employee of the corporation, such as the corporation manager, who has an access to nonpublic information. However, we will see below that the definition of insider in the securities regulation has an important impact on the structure of the corporate governance in the limitation of agency problems. See the section below on the weakening of governance devices.

THE QUARTERLY JOURNAL OF AUSTRIAN ECONOMICS VOL. 5, NO. 1 (SPRING 2002): 3-38

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We discuss here these arguments against insider trading and argue that this type of analysis falls into the trap of Demsetz's (1969, 1989) "Nirvana fallacy" because it fails to engage in what the standard literature calls "comparative economic systems," or what Coase (1964, p. 195) calls "comparative institutional analysis."[2] Such analysis justifies public regulation by emphasizing the existence of discrepancies between the market and an ideal norm that is the perfect market in which costs, uncertainty, and ignorance are absent. Therefore, according to such analysis the only alternative solution is government intervention, which is implicitly assumed as not failing.

We therefore engage in such comparative institutional analysis, and compare two economic systems: the unhampered market or market economy and the hampered market or interventionism. The unhampered market is characterized by a system of private ownership of the means of production in which owners can use their property as they see fit insofar as they do not violate property rights. The hampered market is also based on private ownership, but the fundamental difference is that owners may be coercively prevented from using their property in some way even if it does not imply a violation of property rights. In other words, interventionism "seeks to retain private property in the means of production, but authoritative commands, especially prohibitions, are to restrict the actions of private owners" (Mises 1977, pp. 15-16).

First, we show that, in an unhampered market, means do exist to limit and minimize agency problems that insider trading may create. Second, we demonstrate that government regulations and other interventions in the market increase and make worse agency problems that insider trading is likely to generate. Government interventions hinder the "controlling" function of market mechanisms underscored in our analysis of insider trading in the unhampered market.

It is not argued that agency problems are the result of government intervention in the market economy. To do so we would fall in the same trap as the "Nirvana" approach. We are not arguing that the market economy is a perfect system where there is no error, no conflict, no agency problem, etc., and that such problems are caused completely by government intervention. Our approach is realist; therefore, we do not presuppose that a perfect a system, where agency problems are absent, exists or can exist.

It must be made clear that this article is not a criticism of agency theory, but a criticism of authors who stress agency problems without pointing out solutions provided by both agency theory and corporate-governance theory.

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[2]It should be pointed out that our assertion results from the fact that the author has never found such an approach in the insider trading debate and, in particular, on the issue of insider trading as an agency problem. Traditionally, the debate argues the pros and cons of insider trading and draws conclusions about the desirability or undesirability of a public regulation of insider trading. See also Bris (2000, p. 2, n. 4), pointing out that the literature on insider trading regulations implicitly assumes that there is no such thing as failing governmental regulatory agencies.

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In part two we present the agency-problem argument and its implications for insider trading problems. This argument is an emanation of the separation-of-ownership-and-control theory developed by Berle and Means. In part three, we show that in an unhampered market, shareholders are able to minimize agency problems that insider trading may generate. Part four analyzes the consequences of interventionism on the control relation between shareholders and insiders and the behavior of insiders. Part five offers some concluding remarks.

Insider Trading as an Agency Problem

Some authors argue that one of the main problems with insider trading is that it *inherently* goes hand-in-hand with agency problems. Assume that insider trading is not subject to public regulation and that the firms are free either to allow or to forbid their insiders to trade on nonpublic information. There will be firms that will allow insider trading and other firms that will contractually prohibit it.[3] However, the argument goes, agency problems emerge irrespective of these contractual stipulations.

In firms allowing their insiders to profit from nonpublic information, insider trading cannot help but create a moral hazard problem. Because insiders can profit both from bad news and from good news, they are indifferent to working to make the firm prosper or working to bankrupt it. They may therefore engage in "discretionary" behavior (Levmore 1982, p. 149; Mendelson 1969, pp. 489-90; Posner 1977, p. 308; Schotland 1967, p. 1451). For example, insiders are said to have an incentive to increase the volatility of a corporation's stock prices:

> The opportunity to gain from insider trading also may induce managers to increase the volatility of the firm's stock prices. They may select riskier projects than the shareholders would prefer, because if the risk pays off they can capture a portion of the gains in insider trading and, if the project flops, the shareholders bear the loss. (Easterbrook 1981, p. 312)[4]

Insiders can also conceal or disseminate false information in order to profit by buying and selling mispriced securities (Posner 1977, p. 308). Finally, insiders, and particularly, lower-level managers can delay transmitting important corporate information to their superiors in order to trade on it and make a profit (Haft 1982, p. 1051). Hence, shareholders may have no interest in allowing their insiders to trade on inside information because they will not be able to prevent insiders from engaging in discretionary behaviors (Easterbrook 1981, p. 333).

Moreover, firms that contractually prohibit their insiders from trading on nonpublic information are confronted with an adverse selection problem.

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[3]Here we do not deal with the question of why the shareholders would allow or prohibit insider trading.

[4]See also Brudney (1979, p. 156) and Leftwich and Verrecchia (1981).

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They will not know whether their applicants are being truthful when they say they will respect their contract. Because insider trading is difficult to detect, the firms that wish to ban it will be the prey of unscrupulous insiders.

> Whenever firms write contracts that they do not plan to (or *cannot*) enforce, however, they face a serious problem of adverse selection. Dishonest agents will find employment with the firm especially attractive. They will get their salaries and be able to engage in inside trades as well; they will be overcompensated. To avoid overcompensating the dishonest agents, the firm must reduce salaries across the board. Now the honest agents–those who do not trade on material inside information–will be underpaid and will leave. Bad agents drive out the good. (Easterbrook 1985, p. 94)

Hence, the major problem with insider trading is that, whether or not shareholders contractually prohibit their agents from using inside information to their personal advantage, the shareholders face agency problems. These problems result from the inability to control the activity of their agents.

Interestingly, there is no fundamental difference between the agency argument and the separation-of-ownership-and-control argument. The analysis of insider trading from an agency perspective is only an extension of the separation problem. Berle and Means argue that with the emergence of the modern corporation, characterized by diffused ownership, the firm is no longer controlled by its owners, the shareholders, but by the managers.[5] The managers have interests different from the shareholders, and consequently they can engage in perverse behaviors, against which the shareholders cannot protect themselves because they lack enforcement devices:

> These [agency problems] suggest that granting insiders property rights in their knowledge about the firm is not necessarily beneficial. . . . Michael Dooley asked the right question: If insider trading is undesirable, why do not firms voluntarily curtail the practice? . . . One possible explanation of the firms' failure to do away with insiders' trading on material information–assuming that would be beneficial–is that *they lack adequate enforcement devices.* (Easterbrook 1981, pp. 333-34; emphasis added)

The insider-trading-as-an-agency-problem argument has two dimensions. The first focuses on the negative incentives that insider trading may create in manager's behaviors. The perspective of trading on inside information will incite them to undertake inefficient decisions that harm shareholders. This aspect is directly related to the issue of corporate governance, namely, how

[5]The author considers that Berle and Means is understood as the separation of ownership and control, that is, that managers "abusively" control the corporation instead of shareholders. As Alchian (1969, p. 339) pointed out, there is a difference between saying that there is a dispersion of stock holdings and a separation from ownership and control. The dispersion of stock holdings does not necessarily mean that shareholders are not in control of the corporation.

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shareholders can "control" manager's activity. The second is related to the issue of enforcement of contracts and how shareholders can provide incentives for managers to respect their contract. When shareholders contractually prohibit insider trading, they may not be able to enforce the contracts because of the nature of insider trading, which is difficult to detect. As we have seen, Easterbrook's reply to both questions is in the negative.

However, as we shall now proceed to demonstrate, these arguments are unsatisfactory. Let us first examine how the problem of insider trading is dealt with on the free market.

Insider Trading in the Unhampered Market

The unhampered market or market economy defines "that form of social cooperation which is based on private ownership of the means of production" (Mises 1998, p. 1). We understand social cooperation as a system based on the division of labor and the respect for property rights.[6]

In the unhampered market, there is a whole set of devices allowing shareholders to control the activity of insiders. It is necessary to underscore that some of these devices are more appropriate to address moral hazard problems, and others are intended to solve adverse-selection problems.

Advocates of insider trading prohibition, and, in particular defenders of the insider-trading-as-an-agency-problem argument, seem to overlook the crucial role of property rights and other devices that enable shareholders to exercise their property rights and put pressure on the behavior of insiders.

Property Rights, Shareholders, and the Board of Directors

One of the most important overlooked aspects in the literature on insider trading is the control function of property rights. The very nature of property rights is to allow owners control of what they own. To have a property right to a good means to control this good.[7] It means to control the use, the allocation, and the disposal of goods owned. In the unhampered market, this control is exclusive and absolute (Lepage 1985, pp. 13-14). In other words, controlling the goods owned means that the owner has the right to supremely decide how his goods will be used, to keep the proceeds and returns that result from their use, and to transfer willingly to a third party the whole or part of the specific rights.

Therefore, and due to the very nature of property rights, the shareholders of a corporation, as owners of the means of production, keep the control over

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[6]See Mises (1998b, pp. 258-60) for a complete description of the characteristics of the market economy.

[7]Property rights are in fact a *necessary* condition for human action. Human action is the use of means to satisfy ends either directly (consumer goods) or indirectly (means of production). This presupposes at the outset that the acting person is the owner of the means or, if he is not, that he is authorized by their owner(s) to use them. See Menger (1981, pp. 96-98). See also Campan (1999, pp. 24-26) and Alchian (1977, p. 130; 1969, pp. 352-53).

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the corporation, and not the managers. Mises and Rothbard have well perceived this control function of owners. To be sure, the owners can contractually delegate all or part of this control to managers, and the latter may hold considerable autonomy over the day-to-day operations of the firm. However, ultimately the owners decide:

> Hired managers may successfully direct production or choose production processes. But the ultimate responsibility and control of production rests inevitably with the *owner*, with the businessman whose property the product is until it is sold. It is the owners who make the decision concerning how much capital to invest and in what particular processes. And particularly, it is the *owners* who must choose the managers. The ultimate decisions concerning the use of their property and the choice of the men to manage it must therefore be made by the owners and by no one else. (Rothbard 1995, p. 338)[8]

The fact that shareholders do not participate in each decision in the corporation and instead entrust the board of directors with this task does not mean that they do not have a control over the corporation. On the contrary, they retain the ultimate right of control, which is the "authority to revise the membership of the management group and over major decisions that affect the structure of corporation or its dissolution" (Alchian and Demsetz 1972, p. 788; also Hart and Moore 1990, p. 1121). To be sure, shareholders delegate a great deal of control and authority to the board of directors. In most cases, directors have the responsibility to hire and fire top managers. They have the task of monitoring managers to make sure the managers do not make non-value-maximizing decisions or break their contracts. And above all, they must make sure that the firm makes profits and avoids losses. Shareholders, however, hold the ultimate control of the corporation. If the board of directors does not carry out its task, it will be removed from the management of the corporation and replaced by new directors whom the shareholders judge to be more efficient.

While it can happen that the board of directors does not respect its contract with the shareholders, the empirical evidence suggests that the board of directors generally performs its duty.[9]

Hart argues that the board is ineffective in practice because the board consists of executive directors who are themselves part of the management team, and we cannot expect that they monitor themselves. Moreover, the board consists also of nonexecutive directors who may not perform their duty either because they do not have financial interests in the company or they are loyal

[8]See also Mises (1998, pp. 302-04).

[9]See, for example, Morck et al. (1989), who present empirical evidence that boards of directors perform the monitoring role of management and that the probability of complete turnover of the top management team rises when the firm significantly underperforms in its industry. They also show that when the whole industry is performing poorly, another mechanism, the hostile takeover, ousts the board of directors.

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to those to whom they owe their positions, that is to say, the management who proposed them as directors. Such outsiders want "to stay in management's good graces, so that they can be re-elected and continue to collect their fees" (Hart 1995, p. 682).

To be sure, such a situation may occur. However, this does not change anything: directors never owe their positions to the management; they owe their positions to shareholders, the owners of the firm's assets.[10] And, as owners of the firm's assets, the shareholders have the right to remove the board of directors if they do not fulfill their monitoring role.

One of the mechanisms to remove the board of directors is the proxy fight. Shareholders who are not satisfied with the incumbent board of directors offer a new list of candidates they consider to be more efficient in the management of the corporation. They then canvass other shareholders' votes (proxies) to challenge the direction of the incumbent management. Once the dissident group of shareholders has gathered enough votes, the group is in position to dismiss the incumbent board and replace it with new directors who they believe will be more loyal to them, in the sense that they will manage the company in shareholders' interests. Ultimately, such a change results in the turnover of the management of the corporation.

Some authors have argued that the proxy fight is not a very efficient tool for disciplining managers because of the free-rider problem:

> The dissident bears the initial cost of figuring out that the company is underperforming and also typically incurs the expense of launching the proxy fight–this may include everything from the cost of locating the names and addresses of the shareholders and mailing out the ballots, to the cost of persuading shareholders of the merits of the dissident slate. In contrast, the benefits from improved management accrue to all shareholders in the form of higher share price. Given this, a small shareholder may quite rationally refuse to undertake a proxy fight that is socially valuable. (Hart 1995, pp. 682-83)

Moreover:

> [E]ven if a proxy fight is launched, shareholders may have little incentive to think about whom to vote for since their vote is unlikely to make a difference. A reasonable rule of thumb for a small shareholder may be to vote incumbent management on the grounds that "the devil you know is better than the devil you don't." (Hart 1995, p. 683)

The problem with such an argument is that it overlooks, in the unhampered market, that there is no evidence that the ownership structure would consist of only small shareholders. Actually, we can reasonably argue that in the unhampered market, the ownership would consist of a variety of small,

[10]Such an argument also overlooks the importance of other forces, such as the internal and external managerial competition. This is discussed below.

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medium, and large shareholders. One explanation of such diversity is that the division of labor implies a division of knowledge. Some shareholders have more knowledge of finance, of the business world in general, and of the industry in which they invest, and will hold larger blocks of shares than shareholders who do not have such knowledge. They can more easily monitor management's activity and, in particular, detect the cause of the managerial underperformance when it occurs. Because they hold larger blocks of stocks, such shareholders will have more interest in monitoring the activity of the management and engaging in retaliatory measures if the management's decisions are non-value-maximizing.[11] That is who exercises control over the management.

On the other hand, small shareholders do not have the incentives to monitor the management closely because it is expensive in time and money. Moreover, they may not have the appropriate knowledge to assess the performance of the management. Therefore, the behavior and decision criteria of the small shareholder differ greatly from that of the large shareholder. The small shareholder is only interested in the market price of his shares, the profits or losses made by the firm. If he is not satisfied with the firm's performance, he will not burden himself with finding out why; he will simply sell his shares. Therefore, the rule of thumb for a small shareholder that "the devil you know is better than the devil you don't" is not very realistic. The rule of thumb for a small shareholder should be "it is better to lose a little now than to lose everything later." In some ways, small shareholders are more ruthless than large shareholders.

Now, in light of this, it is difficult to accept that small shareholders will vote for incumbent management. Actually, the presence of large shareholders may convince them that if the latter engage in a proxy contest, it is because they know something (because they actually monitor the management) that small shareholders do not. Therefore, small shareholders may model their behavior on that of large shareholders and vote for the dissident group's slate of candidates.

To be sure, the large shareholder may use his position at the expense of other shareholders (Hart 1995, p. 683; also Shleifer and Vishny 1997, pp. 758-61). But, again, harmed shareholders have the opportunity to sell off their shares.

It is difficult to accept the idea that shareholders are not really in control of the corporation and cannot sanction managers if they make non-value-maximizing decisions. The issue of insider trading does not change anything. Shareholders decide who is entitled to trade on inside information and who is not. If managers do not comply with shareholders' decisions, shareholders

[11]Shleifer and Vishny (1986, p. 478) explain that large shareholders also engage in monitoring because they prefer dividends while small shareholders favor capital gains. They explain this difference of behavior with tax considerations. This also explains the difference of decision criteria when shareholders have to decide whether to sell or to hold their shares.

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or their elected mandataries—the directors—will discharge them. If managers entitled to trade on inside information adopt discretionary behavior, consequences are the same. On the unhampered market, property rights is the ultimate control device for shareholders.

Contract, Contract Law, and Enforcement

In an unhampered economy, contract and contract law are important devices to control the activity of insiders and, more particularly, breaches of contract. The advocates of insider trading prohibition do not see any role whatsoever for contract and contract law to prevent insiders from engaging in discretionary behavior and, in particular, from discouraging insiders not to respect their contractual prohibition to trade on inside information. The insider-trading-as-an-agency-problem argument is based on a tacit premise that insiders will systematically break their contract. However, this theory suffers from two major fallacies.

First, it overlooks the fact that, in a market economy, all contracts are voluntary; that is, both parties agree on the terms of the contract. Therefore, there is no reason why the insider would not respect his contract. Whether insiders are allowed to trade on inside information does not change anything. It is a striking argument to say that because there is inequality of information between shareholders and insiders, the latter will systematically be inclined to break their contract. No significant evidence exists that proves such a tendency. In the market economy, contracts and exchanges are voluntary, and both parties agree on the terms of the exchange. Both parties believe that they will benefit by the exchange-contract. The contract is not a zero-sum game but is always a positive-sum game.[12]

Second, the argument that insider trading inherently involves agency problems overlooks the importance of contract law. A roundabout of production here is necessary in order to understand in what sense contract law acts as a deterrent and sanction device.

A distinction must be established between "contract-as-an-obligation-to-give" and "contract-as-an-obligation-to-do."[13] The contract-as-an-obligation-to-give is typically a bilateral agreement to exchange titles of property.[14] The failure (the refusal) of one of the parties to respect his agreement, that is to say, to transfer his title of property to the other party, is in itself an act of aggression

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[12]See Rothbard (1993, p. 77). Note that when we argue that all contracts are a positive-sum game in the sense that parties always benefit from the exchange, we mean that parties will increase their utility *ex ante*. This does not mean that, from an *ex post* point of view, they have not made an error. See also Rothbard (1993, pp. 768, 772; 1977, pp. 13, 18-19; 1997, pp. 240-41).

[13]Most of our discussion about contract and contract law is largely derived from Kinsella (2001b). The author would like to thank Stephan Kinsella for drawing our attention to his work and, therefore, for having helped to clarify the argument.

[14]For example, when I buy a Porsche for $50,000, I consent to give him $50,000, and he consents to give me the car. We both agree to exchange our titles of property.

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(a theft), and therefore force can be used against the failing party. In other words, contract-as-an-obligation-to-give is enforceable by law because any breach of contract necessarily and implicitly means an act of aggression. By forcing the failing party to transfer his title of property to the other party, the law enforces the contract; that is to say, it recognizes "the new owner, instead of the previous owner" as the legitimate owner of the title of property.

On the other hand, the contract-as-an-obligation-to-do is generally not enforceable (in the sense of using force to make the failing party perform) because it "can be enforced only by threatening to use force against the promisor to force him to perform, or by punishing him afterwards for failing to perform. Yet the promisor has not committed aggression. He has done nothing to justify the use of force against him" (Kinsella 2001b, pp. 5-6).[15] However, it is possible to enforce contract-as-an-obligation-to-do through title transfer as in the case of contract-as-an-obligation-to-give by awarding monetary damages to the injured party. In Kinsella's words, a contract to do something can be defined as follows:

> When a contract to do something is to be formed, the parties simply contract for a *conditional* transfer of title to a specified or determinable sum of monetary damages, where the transfer is conditional upon the promisor's failure to perform. (Kinsella 2001b, p. 7)

Therefore, in the context of insider trading, the contractual prohibition to trade on inside information falls into the category of contract-as-an-obligation-to-do or, more exactly, not-do.[16] When the insider signs his contract and agrees not to trade on inside information, he also agrees to pay a determinable sum of monetary damages if he violates his contract. The threat of being sued for breach of contract and the resultant monetary damages will likely overshadow the incentives for the insider to break his contract.[17]

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[15]It should be noted that a breach of contract-as-an-obligation-to-do might be an act of aggression. For example, when a CPA embezzles a corporation's funds, he is committing an act of aggression (theft) insofar as he misappropriates shareholders' property.

[16]We should add here that the fact that the insider has broken his contract by trading on inside information cannot be considered as theft insofar as shareholders do not have property rights in information. The reason for our argument is that property rights can only apply to scarce resources (economic goods), that is, resources of which "the demand" is greater than the "supply" and of which use prevents other people from using them. In the case of insider trading, the use of (inside) information does not prevent shareholders from using it, nor is it a valid argument that insiders' use of inside information reduces the "value" of inside information and consequently prevents shareholders from using it. We can see the concept of property rights and violation of property rights is inherently related to the notion that a change of physical attributes of the property results from its use. For a similar criticism of the concept of property rights in information (ideal objects) applied to intellectual property, see Kinsella (2001a, pp. 15-25). The author thanks Guido Hülsmann for having drawn his attention to his issue.

[17]These are certainly not the only consequences that the insider may face if he breaks his contract. See the section on reputation, blacklist, and boycotting below. We do not deal here with the issue of the optimal damages to be included in the contract to deter

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Three questions can be raised against our arguments. The first is opportunism.[18] An insider may officially agree to respect the contractual prohibition to trade on insider information while at the same time intending to break his contract if an opportunity presents itself, and if he thinks he can get away with it. In the same vein, the employer may sign the contract because he believes that the employee will respect his contract or that he can prevent the employee from breaking his contract. Therefore, signing the contract does not mean that the insider and his employer demonstrate their preference to perform according to the specified terms of the contract; rather, it demonstrates their preference for signing over not signing.

It is reasonable that the insider may sign his contract while intending to break it if an opportunity arises. However, such an objection overlooks two important points. One, there are other forces at work to discourage the insider from breaking his contract. Two, even if we can accept the idea that the insider may actually plan to break his contract if an opportunity arises, it is difficult to accept such an objection insofar as opportunities are hardly foreseeable. Moreover, even if such an opportunity arose, there is no guarantee that the insider would take it. It depends on whether he believes it is worth doing; after all, if caught, there would be consequences that might include: monetary damages, losing his job, ruining his reputation, etc.

The second objection is that because prosecuting insiders for breach of contract involves costs, shareholders may prefer to renegotiate the contract or even tolerate a certain amount of breach of contract. This argument is both right and wrong. It is right that, because prosecuting for breach of contract may be very costly, shareholders may prefer to tolerate a certain amount of fraud. Nevertheless, it is wrong because if shareholders know that an insider has broken his contract and they tolerate it, there *is* no more fraud but only renegotiation. By not prosecuting or sanctioning, shareholders demonstrate their preference for renegotiation over prosecuting the insider "at fault." Easterbrook's argument is that every time a firm writes a contract it does not plan to enforce, it faces an adverse-selection problem. If such firms do not intend to enforce their contracts, they demonstrate their preference for not enforcing over enforcing them. The problem is not that shareholders tolerate a certain amount of breach of contract but rather that shareholders do not know that the insiders trade on inside information without shareholders' permission. Now we come to the third objection.

The third objection is that insider trading is difficult to detect. Consequently, it is difficult to enforce contracts, and therefore the role of contract and contract law in reducing breaches of contract is insufficient.

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the insider from breaking it. But, see Rothbard (1998, pp. 138-41) on performance *bonds* as voluntary penalty or conditional penal bonds evolved on the market during the Middle Ages and in the early modern period. Penal bonds are monetary damages that the obligator must pay in case of breach of contract to the obligee.

[18]Williamson (1988, p. 569) defines opportunism as a "self-interested seeking with guile."

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Moreover, there is a problem of economies of scale. As Macey (1984, p. 62) argues, this position overlooks the existence of private organizations such as the "New Stock Exchange and the National Association of Securities Dealers which conduct monitoring activities at no charge of the taxpayer." These organizations serve as monitors of illegal transactions; that is, noncontractually allowed transactions on inside information, and provide the information to the shareholders who will decide to sanction the wrongdoer or not (p. 63; see also 1991, pp. 40-41).

The Disciplinary Role of (Hostile) Takeovers

The hostile takeover is the mechanism used when shareholders do not succeed in disciplining managers through internal controls such as the board of directors, large shareholders, or proxy fights. Hostile takeovers, as mechanisms of the market for corporate control, can be considered as the expression of competition that brings together management teams for the right to control, that is to say, to manage corporate, resources (see Jensen 1984, p. 110).

Since Henry Manne (1965), hostile takeovers have been considered by far the most powerful mechanism to discipline managers when they make non-value-maximizing decisions. It provides shareholders with power and protection against mismanagement (p. 112). The takeover represents a threat of displacement for the management that engages in discretionary behavior. When its deterrent effect is not powerful enough to deter managers from engaging in such behaviors, the market for takeovers sets immediately in motion.

As we have previously argued, a takeover substitutes for internal mechanisms when the latter fail to discipline managers. The trigger effect of a takeover process is the perception by a raider of the possibility to realize a capital gain by managing a company whose value might increase if it was managed by a more efficient management team:

> [When the company] is poorly managed–in the sense of not making as great a return for the shareholders as could be accomplished under other feasible managements–the market price of the shares declines relative to the shares of other companies in the same industry or relative to the market as a whole. . . The lower the stock price, relative to what it could be with more efficient management, the more attractive the takeover becomes to those who believe they can manage the company more efficiently. And the potential return from the successful takeover and revitalization of a poorly run company can be enormous. (pp. 112-13)[19]

> Managers of a competing firm . . . almost automatically know a great deal of the kind of information crucial to a takeover decision. Careful analysis of cost conditions in their own firm and the market price of shares of other corporations in the same industry will provide information that can be relied upon with some degree of confidence. (p. 118)[20]

[19]See also Mises (1981, pp. 121-22; 1998b, p. 303).

[20]See also Mises (1981, p. 122).

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Certainly, it could be argued that shareholders will sell their shares only insofar as they detect that managers have made decisions going against shareholders' interests. It might prove a difficult task to determine whether a firm is underperforming because managers are engaged in discretionary behaviors or simply because the firm's environment was unfavorable.

Such an argument implicitly assumes some kind of homogeneity among the shareholders. It assumes that their decisions to sell or not is partly dependent on their ability to determine the reasons for the firm's low value. As we have already argued, in the unhampered market, ownership will consist of both small and large shareholders. Their interests and behaviors will be different. It is likely that small shareholders will not invest time and money trying to determine why firm value is low, or why the company does not make profits. Their main criteria to sell or to hold their shares will be the firm's profit or loss, stock price, and their expectation for future performance. On the other hand, we can expect that larger shareholders will have more incentive to determine the reasons for the firm's underperformance. Their decisions will depend upon the results of their "investigation." If such shareholders, through the board of directors or proxy fights, cannot prevent managers from adopting discretionary behaviors, we may expect that some of them will sell off their shares. It is also correct that some shareholders may not sell their stock because, following their analysis of the situation, they judge that a takeover is very likely and they expect to benefit from it.

The main feature of the takeover device is that even if managers are not deterred from engaging in discretionary behavior, this mechanism always places strict limits on their behaviors (Klein 1999, p. 30). Takeovers play an essential role for shareholders, particularly for small shareholders, in controlling management activity. Shareholders who have neither the ability nor the incentive to monitor the existing management team to ensure that its decisions are in their best interests can always count on "an army of corporate raiders on the lookout for a mismanagement firm" whose performance could be enhanced under new management (Stiglitz 1993, p. 557). Managers know that they are constantly under the monitoring of competing management teams. If they do not work in shareholders' interests, they know that, at any moment, they may be threatened with a takeover and be replaced.

Some authors have questioned, at various levels, the effectiveness of the disciplinary role of takeovers. They argue, first, that takeovers may be ineffective and have no disciplinary value because of a free-rider problem. If, when a competing management team or a raider makes a tender offer during a takeover process, small shareholders who believe that their decisions are unlikely to affect the success of the bid expect an increase in profitability of the firm under a new management, will not tender their shares, but hold them, because the shares are more valuable if takeover succeeds. The raider can only expect to succeed with his takeover if he makes an offer that incorporates all expected capital gains that result from improved management. Under such conditions, the raider does not make any profit offsetting his

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costs of planning the takeover, that is, the costs of identifying and acquiring information about the target. If bids are tendered, then takeovers have no disciplinary effects (Grossman and Hart 1980; Shartstein 1988, pp. 186, 194-95).

This argument fails for two reasons. First, it assumes shareholders know that firm value is low because managers have made non-value-maximizing decisions. However, as we have just argued, it is unlikely that small shareholders will invest sufficient time and money to identify the origin of such firm underperformance because their stakes are small. The benefits for them do not offset the costs. This is why they delegate such responsibilities to the board of directors and the managers (see Klein 1996, p. 19, n. 20). Such behavior is more likely for the large shareholders, whose interests are larger. However, their decisions to tender or not tender their shares depend not only on whether the takeover will succeed but also on whether the new management will be better.

Second, these authors argue that shareholders will not tender their shares because they know that if the takeover succeeds, their shares will *automatically* become more valuable. This statement is not necessarily true. Shares become more valuable and stock prices increase after a successful takeover only if investors expect that the new management will improve the corporation's performance. They may judge correctly, for example, that this takeover is nothing more than a means for new managers to expand their empire, to enhance their reputation and prestige. Or, they may believe that new managers will not succeed in rectifying the corporation's results or that, because this takeover is the result of a diversification strategy, the new management has not the competence to succeed in making the firm profitable. There is no automatic (positive) relationship between the success of a takeover and an increase in share price. The share price will increase if people believe that this takeover is a good thing for the future of the corporation, not because the takeover has been successful.

Some authors argue that takeovers are only a means for competing management teams to expand their empires, aggrandize their power, enhance their reputation or their prestige, and satisfy their egos rather than improve the firm's efficiency (Shleifer and Vishny 1988, p. 14). This kind of behavior appears particularly in companies where management owns a relatively small share of the stock. We certainly cannot deny that the only purpose of some takeovers is to satisfy private interests of a bidder's management team. However, such arguments overlook the fact that companies whose goal it is to build an empire themselves often become takeover targets if they score poorly in performance (see Jensen 1984, p. 114). With the development of high-yield (junk) bonds,[21] the problem of size has been eliminated, insofar as they allow "Davids" to take control over "Goliaths" when the latter are poorly managed (Jensen 1988, p. 39).

[21]High-yield bonds, or "junk" bonds, are bonds rated below investment grade by the bond-rating agencies. These bonds are usually more risky and therefore carry higher interest rates than bonds with investment-grade ratings.

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Critics of takeovers also claim that takeovers may be ineffective disciplinary devices because managers can adopt defensive measures to thwart takeovers. This argument is certainly true, but it is necessary to distinguish defensive measures that are adopted by managers with shareholders' approval from those adopted unilaterally, without shareholders' consent. In the first case, we can distinguish five kinds of antitakeover amendments: the supermajority amendments, fair-price amendments, dual-class recapitalizations, changes in the state of incorporation, and reduction in cumulative voting rights.[22] Empirical studies show that when such amendments are harmful for shareholders, the latter resist adoption of such amendments, and, when adopted, negative stock-price effects follow (Jarrell et al. 1988, pp. 59-62). On the other hand, more harmful for shareholders are antitakeover measures that do not require shareholders' approval. We can distinguish four kinds of such defensive measures: litigation by target management, targeted block stock repurchases (greenmail), poison pills, and state-antitakeover amendments.[23] Such measures are generally very harmful for shareholders because they eliminate the deterrent effect of takeovers on mismanagement. However, it is necessary to point out that such measures are often associated with political decisions at a state or federal level.[24] Therefore, even if it is right that the disciplinary role of takeovers is reduced when managers adopt antitakeover devices, it is difficult to accept that, in the unhampered market, such devices will take place without shareholders' approval. In the same way, it is difficult to accept that shareholders will accept such antitakeover amendments if the latter harm them insofar as they reduce the effectiveness of the disciplinary role of takeovers.

The literature has provided some empirical studies that support our argument that takeovers play a disciplinary role in deterring and sanctioning managers from adopting discretionary behaviors and in aligning their incentives with shareholders' interests.[25] These studies show that turnover in top management increases following takeovers and that there is a correlation with pre-takeover performance of target firms. Targets in which management is replaced after the takeover perform worse than the average firm in their industry and much worse than target firms in which the incumbent management has not been replaced after the takeover.

Takeovers undoubtedly play a disciplinary role in controlling the decisions of managers and insiders. They play a role at two levels: the deterrence

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[22]For a description of such antitakeover amendments, see Jarrell et al. (1988, pp. 59-62).

[23]Ibid. (pp. 62-65) for a description of such antitakeover devices and for reference to empirical studies showing the harmful effect of such defenses.

[24]See Shleifer and Vishny (1997, p. 757). We shall discuss this issue in more detail in the next section on the effect of interventionism in the weakening of corporate governance mechanisms.

[25]See, for example, the works of Jensen and Ruback (1983), Jarrell et al. (1988), and Martin and McConnell (1991).

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and the sanction. Takeovers represent a threat to managers who adopt decisions that are not in the shareholders' interests. If they mismanage the firm, one or several raiders will come to take control of the firm, and they will lose their jobs and be replaced by managers that the raider believes are more competent to manage the firm's corporate resources. Therefore, for managers who are afraid of losing their jobs, the takeover represents an efficient mechanism to limit their discretionary behaviors.

Internal Managerial Competition

The mechanism of competition also plays an important role in controlling the activity of insiders. Managers have career concerns that compel them not to engage in non-value-maximizing behaviors. These career concerns result in competitive behaviors, which play out at two levels: competition between managers and competition between firms.

Managerial competition is one aspect of competition that often has been overlooked by the critics of insider trading as an agency problem. However, Mises (1983, pp. 31-39) showed in 1944 that career concerns play an important role in deterring managers' discretionary behavior (see also Mises 1981, p. 302; Alchian 1969, pp. 340-41, 348; Alchian and Demsetz 1974, p. 788; and Fama 1980, pp. 292-93). This managerial competition plays out at two levels, inside and outside the firm.

Internal managerial competition, which results from career concerns, expresses itself by a manager's will to accede to higher-level positions, or simply to keep the current position. Lower-level managers want to accede to top-level positions and top-level managers want to accede to the highest-level positions—to become the "boss of bosses" (Fama 1980, p. 293). The fulfillment of their plan is dependent on their performance. Either they want to accede to higher-level positions, or they wish to keep their positions. Probably their current performance does not immediately affect their current position, but it impacts on their future position. As we have said, the owners, the ultimate decision makers, will not hesitate to discharge managers if they are unproductive. Consequently, it is in the manager's interest to be successful.

However, a manager's performance is dependent on his subordinates' performance. In other words, the higher-level manager will be considered successful if he has been able to "elicit" productive lower-level managers, that is, profit-making managers. If he fails, he will have to answer to his superior, who will have to answer to his superior. At the top of the hierarchical system of the corporation, the directors will have to answer to the shareholders. If directors fail, they will be discharged and replaced by other directors whom owners expect to be more successful (see Mises 1983, pp. 33-34; 1998b, p. 302). Therefore, because it is in a higher-level manager's interest that his subordinates are profit makers, he will monitor lower-level managers in order to avoid any discretionary behavior. "[S]o there is a *natural* process of monitoring from higher to lower levels of management" (Fama 1980, p. 293; emphasis added).

The internal managerial competition also creates a control process from bottom to top. The manager's will to accede to a higher-level position gives

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him an interest in monitoring higher-level managers. Submanagers have an interest in monitoring higher-level managers because if the latter prove to be unsuccessful, they have the opportunity to take their place. Therefore, they must be alert to these career opportunities.

> Less well appreciated, however, is the monitoring that takes place from bottom to top. Lower managers perceive that they can gain by stepping over shirking or less competent managers above them. (Fama 1980, p. 293)[26]

There is also another important reason to explain this monitoring process. It is in the interest of submanagers to monitor the activity of higher-level managers, because if the latter engage in discretionary behavior, they not only hurt their own interests but also the interests of submanagers.[27]

The double-sense controlling process reduces incentives for managers to engage in perverse behaviors. We can understand now that the moral-hazard aspect of insider trading is considerably reduced. It is irrelevant whether insiders are able to trade on inside information. In all cases, this monitoring process works. Insiders have a strong interest to act in the shareholders' interests and to make as much profit as possible. If they fail, they will be sanctioned either by higher-level managers or directly by the owners of the firm, the shareholders.

Moreover, this internal controlling process exercised between the managers within the firm plays a role in reducing incentives for insiders to break their contracts insofar as contract-breaking insiders are under the "monitoring" of other managers who are ready to take their place if they break their contracts. This monitoring behavior can be explained even if managers work in teams. The managers, being self-interested, are concerned with their own compensation and will not be willing "to take the fall for somebody else."

The External Managerial Competition

The *external* managerial competition is also used as a control device. The external managerial competition puts pressure on managers within the firm to make value-maximizing decisions. As we have already said, the career interests of insiders involve competition between managers within the firm; career interests also encompass competition between managers within the firm and managers outside the firm.

Competition as a rivalrous process "compels" managers (insiders) to give their best. The insider has an interest in honoring his contract, that is to say, in avoiding discretionary behavior and in respecting the insider trading prohibition; for if he fails, shareholders or top managers will replace him with another manager whom they expect to be more successful. This rivalrous process has an important incentive effect on the performance of insiders. It places the manager (insider) in an ejector-seat position. He knows perfectly

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[26]See also Mises (1981, p. 302).

[27]For a similar argument see Carlton and Fischel (1983, p. 874).

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well that if he fails, his future job security will be strongly at risk. Therefore, the external managerial competition acts as a deterrent and a sanction to prevent managers (insiders) from adopting non-value-maximizing behaviors (see Fama 1980, p. 292).

The competitive pressure on insiders comes not only from within the firm but also from outside the firm. It is these two forces combined that reduce incentives for insiders to engage in non-value-maximizing behaviors.

Competition in the Product Market: The Role of the Profit-and-Loss System

The discretionary behavior of insiders can also be controlled through competition in the product market. The competition from other firms gives insiders incentives to give their best. This is a result of the profit-and-loss system.

The profit-and-loss system is the only way to evaluate the satisfaction of consumers. Competition in the product market is a rivalrous process to win the patronage of consumers. If consumers are not satisfied, the firm will suffer losses, and these losses will be imputed to the insiders (managers), who will be sanctioned for their failure.[28] Ultimately, if shareholders believe that the firm suffers too many losses and becomes insolvent, they will sell their shares, and the firm will go into bankruptcy. In both cases, insiders are sanctioned (see Mises 1964, p. 15).

They therefore have a strong incentive to do their best for the company. Thus, we see that competition in the product market monitors managers (insiders) and, in particular, reduces the moral hazard problems of insider trading. It limits the extent to which insiders can engage in discretionary behavior (see Fama 1980, p. 289; also Schmidt 1997; and Raith 2001).

Schmidt shows that the size of the firm does not reduce the incentives for managers to avoid discretionary behaviors insofar as the free entry that characterizes a competitive market always places the industrial giants in front of a risk of liquidation. It is indeed one aspect of a competitive market that a firm never has a secured position. There are many casual examples that demonstrate that no firm is protected from competition. One of them is Microsoft©. Microsoft©, which has been dominating the market of the server-operating-system environment with Windows©, is now confronted with the appearance of such platforms as Linux© (Shankland 2001 and Hewitt 2001).

More important is the competition in the market for product; the more latitude consumers have to select products, the more satisfied and more demanding the consumers will be. Easterbrook argues that if insiders engage in riskier projects in the hope of capturing a portion of the gains in insider trading,

[28]It is also important to recall that the more profit the firm makes, the more attractive the firm will be for potential investors. If the firm is more attractive, the demand for shares will increase and then share price. Consequently, profits will be higher for incumbent shareholders when they sell their shares. Therefore, the profit-and-loss system is another system shareholders have to evaluate the behavior of their insiders (managers) and to sanction them.

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and if the project fails because consumers are not satisfied, the shareholders will bear the loss. The shareholders are not the only ones to suffer a loss; the insiders will lose their jobs.

The competition and threat-of-liquidation effects unambiguously induce managers to avoid adopting non-value-maximizing behaviors.

Reputation, Blacklist, and Boycott

Along with managerial competition, reputation is another important control device that acts as a deterrent and a sanction. Reputation may actually be a crucial factor when an employer has a choice between two candidates of similar background. It provides shareholders with an established appraisal of the person's reliability (honesty). Reputation reduces the incentives for insiders to trade on inside information when it is forbidden in their contract. However, it also works for insiders who are *allowed* to trade on inside information. In this case, it guides them to avoid behaviors going against shareholders' interests.

Reputation is the expression of value judgments of others (Block 1976, pp. 59-62; also Fombrun and Van Riel 1997, p. 5). In the context of business, these value judgments result from others' appreciation of the manager-insider's competence and reliability. Reputation is evaluated through past performance, previous positions, the reputation of companies for which he has worked, his awards (for example, best CEO of the year), etc. Reputation is the reflection of past actions; it does not mean that because a manager has a very good reputation, he will not engage in a discretionary behavior or break his contract if he has the opportunity to do so. A reputation is just a business card that conveys some degree of reliability that saves the employer time and money in checking information provided by the employee, because even if people build their reputation through their actions, their reputation always results from the perception of others. Managers consequently have an interest in behaving in the shareholder's interests, working hard, and having a good record. A manager's reputation is important because it has an impact on the corporation's reputation.[29] Therefore, it is in the manager's interest to maintain a good reputation if he wants to keep his job or find a new job.

Reputation is then a deterrent and a signal device, but it can also be a sanction device. For example, the shareholders or their mandataries will be able to publicly criticize the insider at fault for not having respected his contract. As a consequence, this insider will not only be sued under contract law, but will see his reputation suffer, and he will not be able to do anything about it. This inability to fight against a bad reputation following a breach of contract results from the fact that the individual is not the owner of his reputation. Blacklisting and boycotting are legitimate on the unhampered market and allow shareholders to protect themselves against breaches of contract by insiders.

[29]For example, Burson-Marsteller's (2001) recent research finds that CEO reputation can represent 45 percent of a company's reputation.

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Following a breach of contract, shareholders may publicly disseminate a "blacklist" of managers (insiders) who have poor records or who have broken their contracts by trading on inside information when contractually forbidden to do it.[30]

Shareholders can also urge other corporations' shareholders not to hire the insiders in the wrong. The boycott is a way to sanction insiders for having broken their contracts (see Rothbard 1993, p. 154).[31]

Therefore, insiders have an interest in not breaking their contracts by engaging in perverse behavior or trading on inside information. Reputations, blacklists, and boycotts are powerful deterrents and an important means of sanction against agency problems.[32]

One limitation to the reputation mechanism is that when agents are coming close to the end of their careers, the incentive to maintain a good reputation decreases.[33] This limit, however, is mitigated by the competition on the managerial market insofar as the older manager will find it more difficult to find a new position at the same level.

The reputation mechanisms undoubtedly play a role in mitigating agency problems that insider trading may create even if we cannot deny that they are not enough to resolve agency problems by themselves (Holmstrom 1982). Rather, it is the combination of the various mechanisms previously described that significantly reduces the incentives for insiders and managers to engage in discretionary behaviors.

Insider Trading in the Hampered Market

When we examine the control relationship between shareholders and insiders (managers) in the context of the unhampered market, it is difficult to accept the idea that there is such a thing as separation of property and control.[34] Berle

[30]One could challenge our argument that such mechanisms work only as soon as insider trading is detected. As we have argued, market organizations can play this monitoring role. The probability of detection increases the more effective the deterrent is. Such an argument might have been true fifty years ago, but it is difficult to advance such an argument today, and it will be increasingly difficult to advance it in the future. To be sure, there is always a chance to slip through the net. Again, we do not argue that such mechanisms are perfect.

[31]See also Rothbard (1998, pp. 131-32) for a defense of blacklist and boycott from a property rights perspective in the libertarian tradition.

[32]In the real business world, some forms of blacklist and boycott exist. For example, it is usual for an employer to call previous employers or individuals for their opinion of the applicant. It is why potential employees are usually asked for references. It is a fact of the real world that employers do not rely only upon the job applicant's résumé and his oratorical skills during interviews. Reputation plays an important role in the labor market at all levels.

[33]The recent literature in managerial economics increasingly recognizes reputation as a disciplinary mechanism. See Brickley et al. (1996, pp. 161-62).

[34]"The emergence of an omnipotent managerial class is *not* a phenomenon of the unhampered market economy" (Mises 1998b, p. 304; emphasis added).

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and Means's theory is hardly tenable when it is applied to the insider trading problem. To be sure, there are principal-agent problems, but the market can solve them.[35]

The corollary of this proposition is that, as soon as the control relation between shareholders and insiders (managers) is destroyed, or, at least, is strongly lessened, agency problems generated by insider trading worsen. Therefore, we now have to examine the causes of this phenomenon.

The Nature of Interventionism

Before analyzing the implications of interventionism for insider trading in a hampered market, it is useful to briefly state the nature of interventionism.

We have already pointed out that interventionism, as an economic system, is different from the market economy in the sense that, even if the system is still based on private ownership of the means of production, the owners are not free to use their property as they see fit. In other words, interventionism is characterized by a set of authoritative commands and prohibitions that seek to restrict the actions of private owners. The coercive nature of interventionism involves several consequences for the behavior of market participants.

The first consequence of interventionism is that coerced owners of the means of production will act "in a way different from what they would do" in an unhampered market:

> *Interventionism is a limited order by a social authority forcing the owners of the means of production and entrepreneurs to employ their means in a different manner than they otherwise would.* (Mises 1977, p. 20; emphasis in original)[36]

Another consequence of interventionism understood as a set of restrictive measures is that, most of the time, it results in a set of privileges. Interventionism "brings advantages to a limited group of people while it affects adversely all others, or a least a majority of others. . . . The interventions, therefore, may be regarded as privileges, which are granted to some at the expense of others" (Mises 1998, p. 19).[37]

Finally, interventionism always results in conflicts of interest. Each individual wants to be granted a privilege, that is to say, to be the "net gainer" rather the "net loser" (Rothbard 1993, p. 769). The very nature of interventionism is conflict. It hampers the use that owners can make of their property rights, and consequently it creates conflicts of interest because it allows some individuals to get gains at the expense of others. Contrary to the market economy where each actor tries to satisfy the interests of other people in

[35]To say that the market can solve every agency problem does not mean that it solves them all. Errors can be made.

[36]See also Mises (1998, p. 10) and Rothbard (1993, p. 768; 1970, p. 13).

[37]See also Hayek (1995, p. 156).

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order to better satisfy his own interests, under interventionism, each actor tries to satisfy his own interests to the detriment of others.

In identifying the nature of interventionism and its general consequences on individuals' behavior, we can analyze the consequences of interventionism for the relation between shareholders and insiders and for insiders' behavior. We will show that interventionism strongly lessens the control of shareholders over insiders, and that the latter, as a consequence, are allowed to engage in behaviors denounced by proponents of insider-trading-as-an-agency-problem argument.

The Weakening of Governance Devices

The prime effect of interventionism is to hamper shareholders in the exercise of their property rights since it involves a transfer of power from shareholders to managers (insiders). This phenomenon gives rise to a separation of property from control. In other words, government's interference in the market creates the emergence of an omnipotent class of insiders (managers). Commenting on this impact of interventionism, Mises observed:

> [The emergence of an omnipotent managerial class] was, on the contrary, an outgrowth of the interventionist policies consciously aiming at an elimination of the influence of the shareholders and at their virtual expropriation. (Mises 1998b, p. 304)

In emphasizing the consequences of interventionism for the control relation between shareholders and managers (insiders), Mises anticipates recent work. Shareholders are no longer able to control their insiders, and consequently, the latter can adopt non-value-maximizing behaviors or break their contracts. In the same way, some recent works on "comparative corporate governance" have tried to show the interaction between politics and governance in the United States. Roe's works lead him to the same conclusion as Mises:

> The analytic result is fundamental: the modern American public corporation is not an inevitable consequence of technology that demands large inputs of capital. . . . Politics confined the terrain on which the large American enterprise could evolve. . . . By restricting the terrain on which the large enterprise could evolve, *politics created the fragmented Berle-Means corporation.* (Roe 1994, pp. 284-86)

With the emergence of Berle-Means corporations, control shifts to managers. Owning the control, insiders (managers) are more able to engage in behavior going against the interests of the shareholders. This "virtual expropriation" of shareholders by managers and the prevalence of managerial behaviors that do not serve the interests of shareholders is not a phenomenon of the unhampered market; rather it is a phenomenon of interventionism because shareholders have less control of their property rights.

Several regulations have especially contributed to the lessening of the control relation between shareholders and their insiders: legal restrictions on

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financial institutions, insider trading regulation, antitrust regulation, state and federal antitakeover restrictions, and contract and labor legislation.[38]

According to Roe, legal restrictions on financial institutions taking large stock positions were key to the weakening of the control relation between shareholders and managers (insiders):

> The regular prohibition on financial institutions' taking large stock positions was crucial to the development of the Berle-Means corporation, with its fragmented share ownership. . . . Managers eventually benefited from this fragmentation. (Roe 1994, p. 93)

In the United States, banks, mutual funds, and pensions are either barred from the securities business and from owning stock or are significantly restricted in their portfolios and cannot easily devote their portfolios to big blocks. Moreover, some financial institutions, such as mutual funds and pensions, face legal and structural problems that prevent them from going into the boardroom. The general consequence of these legal restrictions is that ownership has been diffused and a shift of power from owners to managers has taken place (p. 283).

Another factor that imposes a deterrent effect on ownership is the insider trading regulation and Section 16 of the Securities Exchange Act of 1934, which includes in the definition of "insider" any beneficial owner holding more than 10 percent of a company's stock. Therefore, considered as insiders, shareholders are necessarily monitored by the Securities and Exchange Commission and are prohibited from making any insider trading transactions as defined by the insider trading regulation (ECGN 1997, p. 12; Beny 1999, pp. 18-19; also Bris 2000, p. 24). The impact of such regulation is the same as the regulation of ownership by the financial institutions, such as banking, insurance, and investment companies, and pension funds. For smaller investors (institutional or not), the incentive to monitor management is reduced because their stake in the company is smaller and, consequently, the benefits of the monitoring are reduced.[39] Another consequence is that if managers are less monitored, they have more latitude to engage in discretionary behaviors or break their contracts. Finally, the last consequence is that such a rule increases the costs of a takeover because it increases the cost of acquiring a majority of shares in a potential target, since the ownership is dispersed among many shareholders.

Federal and state antitakeover restrictions lessen the role of takeovers in disciplining the activities of managers. A fundamental consequence of such

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[38]We do not deal here with all regulations in detail because of their overwhelming number. However, it is important to give some illustrations to understand how such regulations can hamper the functioning of the corporate governance mechanisms that help to minimize agency problems.

[39]See Maug (1999, pp. 24-25). See also Seyhun (1998, p. 31): "[M]any large investors prefer to keep their ownership below the 10 percent level that would trigger the insider status . . . insider trading laws in fact discourage monitoring."

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regulations is that insiders feel protected; they are no longer deterred from engaging in non-value-maximizing behaviors.[40]

The 1968 Williams Act to the Securities Exchange Act of 1934 enables managers (insiders) to easily thwart a takeover.[41] It requires that acquirers *disclose* their acquisitions to the Securities and Exchange Commission along with any other information necessary or appropriate in the public interest for the protection of investors, *after* they purchase more than 5 percent of the outstanding shares on the open market.[42] Rule 14(e)-3 also hampers market control in favor of corporate control.[43] It then prevents acquirers from having recourse to arbitrageurs to make takeovers easier.

In Europe, legislation compels any person or legal entity to disclose within seven calendar days to the concerned company and regulatory agency of the member state in which the company is settled any acquisition or disposal of "a holding in a company and where, following that acquisition or disposal, the proportion of voting rights held by that person or legal entity reaches, exceeds or falls below one of the thresholds of 10 percent, 20 percent, 1/3, 50 percent and 2/3" (Council Directive 1988). The community legislation adds that "Member States may provide that a company must also be informed in respect of the proportion of capital held by a natural person or legal entity." The effect is the same as for the Williams Act, insofar as such legislation helps managers to adopt antitakeover measures in cases where acquisition of a large block of shares would precede a raid.

Much has been written about the harmful consequences of state antitakeover regulations and defensive measures, such as poison pills, that do not require shareholder approval and that have been enforced by state Supreme Court decisions.[44] The literature generally agrees that such measures are harmful to shareholders because they shield managers from the disciplinary role of takeovers.[45]

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[40]See Block and McGee (1992, p. 225, n. 24) accompanying text for references arguing against federal and state antitakeover restrictions.

[41]See also Scharfstein (1988, p. 196), which shows such federal takeover regulation as the 1968 Williams Act, which gives shareholders more time to evaluate a takeover and, if they perceive that such a takeover may benefit them, they will not tender their shares at a low price and, therefore, will unintentionally wreck the takeover.

[42]See 15 U.S.C. §§78m(d)-(e) and 15 U.S.C. 78n(d)-(f). See also amended sections 13(d)-(e) and 14(d)-(f) of the Securities Exchange Act of 1934 that includes now the 1968 Williams Act.

[43]Rule 14(e)-3 makes it illegal for anyone to trade the securities of the firm involved in a tender offer while in possession of material, confidential information. See 17 C.F.R. §240.14e-3.

[44]See, for example, Jarrell et al. (1988, pp. 62-65) for an account of antitakeover measures that do not require shareholder approval. The Delaware Supreme Court's 1985 ruling in *Moran v. Household International* is usually cited as the first state enforcement of adoption of antitakeover measures not requiring shareholder approval.

[45]See Jarrell et al. (1988) for an account of empirical studies reporting the undoubtedly harmful effects of antitakeover measures and of state antitakeover regulations.

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Another factor that contributes to the weakening of the control relation between shareholders and managers (insiders) is the nonenforcement by the courts of the contract and, in particular, the voidance of penalty clauses.[46] The direct consequence of such intervention is the possibility that not paying monetary damages gives insiders more incentives to break their contracts.[47]

Labor legislation has also contributed to lessening the control relation between shareholders and managers (Mises 1983, pp. 69-71; also Roe 1994, p. 39). It interferes at several levels and hampers governance mechanisms that would prevent insiders from either mismanaging the shareholders' corporate resources or breaking their contracts. For example, the interference with the freedom of contract by regulating the conditions of redundancy allows the managers greater latitude to engage in discretionary behaviors.[48]

The separation of ownership and control, understood as the lessening of the control relation of shareholders on insiders (managers), is *not* a consequence of a general evolution of the market process. On the contrary, as Mises and later Roe have shown, this phenomenon results from the meddling of government in the market. The separation-of-ownership-from-control phenomenon emerges with interventionism.

Some authors have tried to challenge Roe's theory by arguing that the emergence of the Berle-Means corporation is not the result of government

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[46]For example, the Uniform Commercial Code states:

> Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty. (U.C.C. §2-718)

Under the Uniform Commercial Code, the question of whether damages are "unreasonable" may be determined not only at the time the contract is signed, but also *ex post* in light of the actual harm suffered by the parties. Moreover, the rationale for the nonenforcement of penalty clauses is that parties are not free to establish remedies, since that is the role of public law rather than private contractual law.

[47]See also Rothbard (1998, pp. 140-41), explaining the suppression of performance bonds as resulting from a misunderstanding by the courts of the concept of contract enforcements. Rothbard argues that the role of contractual enforcement is to make sure that agreements are performed, not to provide compensation for loss suffered by failure to perform agreements.

[48]The French case is a perfect example of such interference with freedom of contract and of regulation of labor conditions. The new law on "social modernization" adopted by the Assemblée Nationale is the most recent case of such interference that illustrates how government interventions indirectly hamper the disciplinary role of contract, contract law, and competition in general. When employers cannot let their employees go because the firm is underperforming in the industry, employers do not have incentives to avoid non-value-maximizing behaviors. See Assemblée Nationale (2001, pp. 32-42).

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interventions in the market but rather can be explained by the degree of minority-shareholder protection (La Porta et al. 1997, 1998, 1999). They argue that in countries (generally common-law countries such as the United States or the United Kingdom) with good legal protection of minority shareholders, ownership is widely dispersed. On the contrary, in countries (generally civil-law countries such as France, Italy, Germany, and Belgium) with poor legal protection of minority shareholders, ownership is usually concentrated. Beny (1999), Maug (1999), and Bris (2000) have extended La Porta et al.'s studies and applied them to the insider trading issue. They show that where insider trading laws (interpreted as legal protection of minority shareholders) are tougher, ownership is more dispersed. Unfortunately, such studies are wandering from the Mises-Roe argument in three ways.

First, the issue is not the structure of ownership (concentrated or dispersed) but the expropriation of shareholders by the managers. The definition of Berle-Means should not be understood in terms of degree of ownership concentration (or dispersion) but rather in terms of degree of control that shareholders have on managers' behaviors. It is not whether ownership is dispersed or concentrated but rather whether shareholders have lost control of the corporation, that is, whether shareholders can no longer discipline managers' behaviors. Ownership can be concentrated and shareholders can still be harmed by the managers' discretionary behaviors.[49]

Second, such studies cannot be considered as challenging the Mises-Roe argument insofar as they make a comparison between two systems characterized by more or less intervention. Such studies only show that in countries where property rights are less hampered and contracts are more enforced, equity markets are both broader and more valuable than in countries where property rights are more hampered and contracts less enforced. This point is illustrated perfectly by their observation that corporations in civil-law countries are typically controlled by the State (such as in France), while corporations in common-law countries have been under dispersed ownership. Their comment about State-controlled corporations is without appeal; such corporations are "extremely inefficient" and expropriate minority shareholders. Moreover, they show that such countries are also marked by more corruption because of the strong bond with the political sphere (Shleifer and Vishny 1997, pp. 767-69). Finally, such studies show that in civil-law countries, insider trading scandals usually have a connection to political power. The Triangle Industries scandal is one illustration. The scandal involved insider purchases of Triangle shares shortly before Pechiney bought it in 1989. Among the six French buyers who were indicted for insider trading, one (Roger-Patrice Pelat) was a close, longtime friend of the president of the Republic. Two others (Max Théret and Harris Puisais) were also close to political power (Bris 2000, p. 9).

[49]See after.

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Third, studies applied to insider trading, in the same spirit as La Porta et al., investigated expropriation of minority shareholders by large shareholders. Unfortunately, we cannot consider whether there is any expropriation of minority shareholders when large shareholders trade on inside information insofar as large shareholders have as much legitimacy to trade on inside information as minority shareholders. The fact that large shareholders have easier and less costly access to inside information does not invalidate such legitimacy to trade on inside information.[50]

The Encouragement of Discretionary Behavior

Our analysis has shown consequences of interventionism on the control relationship between shareholders and insiders. As soon as this control relationship is weakened, insiders are able to engage in breaches of contract. Now we will show briefly that securities regulation–and, more specifically, insider trading regulation–is not able to substitute or complement the market to solve agency problems. On the contrary, insider trading regulation worsens them, in the sense that it inclines insiders to develop new forms of behavior in order to trade. This results from the arbitrary nature of any regulation.

Because restrictive measures are arbitrary, insiders have no difficulty finding strategies to escape regulation. Several examples illustrate this point.[51]

Section 16 (b) of the Securities Exchange Act of 1934, also called *insider's short-swing profit rule*, prohibits any transaction involving purchases and sales within a six-month period. The weakness of such a rule is that insiders have only to make a transaction within six months and one day, and they are not under the prohibition.[52]

From 1980 to 1997, the very definition of insider trading (as a fraudulent activity) relied on the concept of "fiduciary duty" (*Chiarella v. United States* 1980, pp. 227-28).[53] First, this allows an insider to engage in inside information exchange with insiders from other corporations, or to give inside information to someone who will undertake to trade on the insider's behalf.

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[50]See, for example, Easterbrook (1981, p. 330) on the inconsistency of characterizing insider trading as fraudulent following the argument that insider trading is unethical because access to inside information is unequal between insiders (large shareholders, management) and outsiders (minority shareholders, potential shareholders).

[51]It seems necessary to point out that the regulation of insider trading has been amended many times at the mercy of the U.S. Supreme Court, making some of our examples no longer valid. However, our point is rather to show how the regulation of insider trading, because of its arbitrary nature, can reach some paradoxical results.

[52]As Manne (1966, p. 30) explained, this rule did not have the expected effect, that is, a reduction in insider trading activities and profits realized by insiders, and that is why the SEC asked for a broad rule against all trading with inside information but the Congress expressly declined such an option. But, in 1942, the SEC had recourse to Rule 10(b) of the Securities Exchange Act of 1934 and adopted an application rule, rule 10b-5. See Georges (1976, p. 94, n. 1) and Manne (1966, p. 34).

[53]See Strudler and Ort (1999, p. 389) for a restatement of the definition of insider trading as a fraudulent activity based on the fiduciary-duty principle:

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Manne (1966, pp. 59-75) described this behavior and the emergence of a "black market" for private information in order to escape insider trading regulation.[54] Moreover, such a definition of fraudulent activity excludes from the scope of the regulation persons who have a non-full-time contractual relationship (outsiders) with the corporation (see Easterbrook 1996, p. 269). The *Chiarella v. United States* case–the case to define insider trading as a breach of fiduciary duty–is a typical case of some paradoxical consequences to which an arbitrary rule can lead. Chiarella, an employee of a financial printing house that printed announcements for corporate takeover bids, deciphered documents concerning takeover clients. Chiarella was able to identify five companies, and he purchased stock in the targeted companies. Chiarella was not convicted because, first, he never received confidential information from the target companies and, second, he did not owe any fiduciary duty to the target company's shareholders from whom he bought shares. However, Chiarella did trade on confidential information belonging to the printing house's client. The question that arises is: did the client bidder allow him to trade on information that he could "discover" in their contractual relationship? The reply is that documents Chiarella had to print for the client bidder were encoded. Therefore, we can implicitly assume that the client bidder would not have allowed him to trade on information that he could discover during his work. Chiarella clearly broke his contract with his employer but was not convicted because of the "fiduciary-duty" doctrine.

We have the same kind of paradoxical consequences with the recent *O'Hagan* case (*United States v. O'Hagan* 1997), which is an updated version of the misappropriation theory and of the fiduciary-duty doctrine. In this case, the conviction was established on the fact that the defendant had broken his fiduciary duty that he owed, not to stock market investors, but rather to the company's shareholders, who were the legitimate owners of the inside information. Here, the definition of insider trading (as a fraudulent activity) relies on a new version of fiduciary duty. The fraud is committed when the person misappropriates inside information for securities trading purposes in breach of duty owed to the source of the information (pp. 7 and 28, n. 6). The problem of such a definition of insider trading (as a fraudulent activity) is that

> Insider trading is wrong because whenever it occurs, the inside trader breaches fiduciary duties owed to the trader's principal, namely, the corporation or the corporate shareholder with whom he engages in securities transaction. By trading without disclosing material non-public information to the principal, the insider violates a duty owed to the principal corporation or its shareholders.

[54]In an unhampered market, such a market would not emerge because all contracts are voluntary. Therefore, both parties will expect *ex ante* that they will be better off after contracting than before contracting.

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the only criterion to escape a conviction is for the insider to disclose the source of information and his intentions to trade on inside information (p. 8). The liability lies in the nondisclosure of insider's intentions and not in the authorization. Therefore, the insider only has to disclose his intention to escape the liability for insider trading; he does not need to have the authorization from the source of the information, namely, the shareholders.

Another example is that securities regulations compel corporations to publish financial information according to well-defined accounting criteria in order to increase the informational equity, namely, the equal access to information for market participants.[55] Such regulation is supposed to reduce insiders' profits resulting from their privileged access to information. The problem is that these criteria are arbitrary, and consequently insiders can keep the material information in order to trade on it.[56]

Alternative behaviors to avoid regulations are a common reaction to interventionism. Because any regulation is based on *arbitrary* criteria, individuals will engage in alternative behaviors to reach their ends.

We can find empirical studies that have tested the efficiency of regulation on the volume of insider trading, the volume of inside transactions, and the profitability of inside transactions that support our analysis. For example, Seyhun (1992) investigates the effectiveness of increased federal regulation of insider trading and its sanctions on a period from January 1975 to December 1989. The study only examines insiders' open market sales and purchases. He finds that (1) the profitability of insider trading has increased; (2) there is no evidence of a decline in the frequency; (3) the volume of trading by insiders has doubled; and (4) insiders have become more aggressive in exploiting the private information by trading larger volumes over time. Seyhun explores the relative deterrent effects of federal regulation and case law on insider trading around specific events. He finds that, at the time when earnings are announced, insiders' transactions decrease significantly, and that in the thirty days prior to takeover bids, the volume of trading activities of insiders

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[55]The Securities Act of 1933 regulates the information that must be disclosed to investors in new securities issues. The Securities Exchange Act of 1934 regulates periodic disclosure of financial information by publicly owned corporations. The other reason for such regulations is to encourage people's participation in the securities market. See also the European Community legislation in force: Council Directive 80/390/EEC (1980), coordinating the requirements for the drawing up, scrutiny, and distribution of listing particulars to be published for the admission of securities to the official stock exchange listing; Council Directive 82/121/EEC (1982), on information to be published on a regular basis by companies with shares that have been submitted to the official stock-exchange listing; and *Council Directive 89/298/EEC* (1989), coordinating the requirements for drawing up, scrutiny, and distribution of the prospectus to be published when transferable securities are offered to the public.

[56]See Benston (1969, 1973, 1982, 1998), who shows that this consequence results from the harmonization of accounting rules to report financial information. Such harmonization results in the removal of all subjective information, such as intangible assets.

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decreases. He concludes that while the federal regulation of insider trading does not appear to have a significant deterrent effect on insiders overall, "court cases regarding insider trading around earning and takeover announcements did affect insider trading patterns" (p. 176).

The Seyhun study is consistent with our argument that federal insider trading regulation is inefficient and that such regulations do not deter insider trading but rather give incentives for insiders to generate alternative and strategic behaviors to escape regulation.[57]

In a more recent study, Bris analyzes the effects of insider trading regulation in fifty-six countries and shows that laws that prosecute insider trading make it more profitable to violate them and fail to eliminate profits made by insiders around tender-offer announcements. He shows that the tougher the laws, the more profitable the opportunities to insiders, due to (1) the fact that the increase of stock liquidity resulting from insider trading laws gives more insiders opportunity to hide informed trades, and (2) the fact that uninformed investors participate more if they infer that insiders are not going to take advantage of them (Bris 2000, pp. 9, 23).[58] "Therefore, the expected penalty from being prosecuted by the regulator decreases," and the volume of insider trading increases (p. 15). Finally, consistent with our criticism of interventionism, he shows that the profitability of insider trading is lower in common-law countries (United States, United Kingdom, Australia) than in civil-law countries (France, Spain), not because insider trading regulations are efficient but because shareholders' property rights are better protected and contracts are better enforced.

What we have to remember about interventionism and, in particular, the regulation of insider trading deals with the agency-problem issue is, first, interventionism neither substitutes for complements the market mechanisms in resolving agency problems that insider trading raises. Second, interventionism

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[57]It could be argued that our argument is flawed because the increased number of insider trading convictions is evidence of the effectiveness of insider trading regulation. However, this argument is erroneous in the sense that insider trading regulation (as any prohibition) should be considered as effective not when the number of convictions increases but when it decreases. It is the deterrence impact that is crucial as a measure of the effectiveness of insider trading prohibition. From a statistical point of view, an increase in the volume of convictions and crimes is not a measure of effectiveness, but of ineffectiveness.

[58]See also Holden and Subrahmanyam (1992), Foster and Viswanathan (1993), and Spiegel and Subrahmanyam (1995).

Two factors may explain why investors participate more. First, the insider trading regulations create the illusion that there is no insider on the stock market to "take advantage" of their "ignorance." Second, the rules about publications of corporate information create the illusion that they are "equally informed." It is necessary to recall here that the main purpose of insider trading regulations has been to place investors on a "level playing field," that is, to place investors on an equal footing for the access of information and for profit-making on the stock market. See, for example, Council Directive 89/592/ECC of 13 November 1989, coordinating regulations on insider trading in Europe.

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actually hampers these market mechanisms and consequently makes these agency problems worse. Finally, interventionism gives incentives for insiders to adopt alternative and strategic behaviors to escape regulations.

The first result of interventionism is to shift control from shareholders to managers (insiders). The second result is that insiders adopt alternative (perverse) behaviors in order to get net gains offered by interventionism. Advocates of the insider-trading-as-an-agency-problem argument denounce these perverse behaviors. However, they do not result from a natural evolution of markets, but from government meddling with the market.

Conclusion

The insider trading debate traditionally discusses the pros and cons of insider trading and draws a conclusion about the desirability or undesirability of public regulation of insider trading. One of the most important arguments against insider trading is that it generates agency problems that shareholders cannot resolve and that, therefore, insider trading should be publicly regulated. We have challenged this argument for failing to engage in comparative institutional analysis. We argued that when the negative aspects of insider trading, namely, the agency problems that it may create, are considered, it is necessary to engage in comparative institutional analysis and how these problems can be resolved under two different economic systems: the market economy and interventionism.

We have been led to the conclusion that under a market economy, shareholders do have mechanisms to protect themselves against agency problems generated by insider trading and that these problems are reduced to a minimum. We have shown that interventionism hampers the functioning and reduces the disciplinary role of such mechanisms. Therefore, insiders have indeed more latitude to engage in these discretionary behaviors, pointed out by the supporters of the insider-trading-as-an-agency-problem argument, that harm shareholders. Finally, we have shown that the failures of government regulation reinforce this tendency of insiders' behavior.

We conclude that we cannot justify a public regulation of insider trading based on the insider-trading-as-agency-problem argument.

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Ownership, Scarcity, and Economic Decision Making

Dan Mahoney

A central theme of all schools of economics is the notion that goods are scarce. The extent of human wants and needs is sufficiently great that the means man would apply to those ends are limited, requiring that he choose among alternative actions. The purpose of this article is to call attention to a facet of scarcity that stems from this fundamental notion and that is of relevance to economic decision making, the determination of what goals to pursue, and how to attain them. This facet is the ownership of these scarce goods. The fact of ownership means that there is an additional problem faced by those who would use such goods, beyond the fact that such goods are physically unable to satisfy all conceivable uses to which they could be put. This problem is how to convince the owner, who by the very meaning of ownership is entitled to complete control over those goods, to part with those goods (so that they may be applied to other uses).

Since some owners may be more willing to part with those goods than others, the notion of how scarce some good is for a particular use cannot be answered outside the context of ownership and the valuations of property owners, making scarcity in this sense subjective as well. The existence of and need for property is a consequence of scarcity, which is further affected by the very institution to which it gives rise. However, this "problem" in a sense supplies its own solution, as ownership implies the ability to exchange, and consequently, the emergence of exchange ratios in a common unit (that is, money prices) that permit economic calculation and thus the ability to coherently compare prospective courses of action.

This article will attempt to elaborate on this idea, and applications of this notion will be made to the problems of socialism, monopoly capitalism, and business cycle theory.

Dan Mahoney is senior research analyst at Mirant Americas. The author would like to thank Professors Guido Hülsmann, Walter Block, and two anonymous referees for their helpful comments on an earlier draft of this paper. As usual, any remaining errors are mine.

THE QUARTERLY JOURNAL OF AUSTRIAN ECONOMICS VOL. 5, NO. 1 (SPRING 2002): 39-56

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Scarcity in the General Sense

We live in a world characterized by scarcity. That is, the physical amount of the things man would use to satisfy his wants and needs are limited in relation to those wants and needs.[1] It is for this reason that conflicts can arise over things: if goods were so plentiful that another's use of them would not preclude my use of them, then no disagreements could arise over their use. It is because of the possibility of such conflicts that some means of conflict resolution is needed, and this is precisely why any theory of conflict resolution–ethics–is ultimately a theory of property rights (Rothbard 1998; Hoppe 1989, 1993). When scarce goods become owned, then conflict over their use is resolved (at least in principle). These goods then become *property*, and as the owner of property, I am entitled to exclude others from the use of the goods manifesting themselves as property. Of course, questions as to how property may be justifiably acquired must be resolved,[2] but once such questions are addressed, economic interactions between men become exchanges of property under a system delineating how such exchanges may legitimately take place.

Thus the concept of property stems from that of scarcity. This connection has long been recognized. Menger (1976, quoted in Salerno 1999) argues that

> [A person's] property is not . . . an arbitrarily combined quantity of goods, but a direct reflection of his needs, an integrated whole, no essential part of which can be diminished or increased without affecting realization of the end it serves. (p. 84)

Salerno further notes that property is "a praxeological category that refers to a purposively created structure of goods that is adjusted through the operations of economizing to serve the structure of ends aimed at by an individual actor" (p. 84), the need for which (economizing) is entirely due to the fact of scarcity. Scarcity is a fundamental concept of economics and, more generally, of human action, as we confront scarcity with every action.

Unowned goods become property precisely because their use by one person means that others will be unable to use them. When a good is unowned (for example, in a state of nature), the question of acquiring it and making it one's property is a question, as with all actions, of choosing one course of action over another. However, given a system of property rights that determines how goods may be justly acquired, interactions with others do not necessarily arise. That is, as an unowned good, no one else has any justifiable claim over it. Others may desire it or hope the prospective owner puts it to a certain use, but in attempting to obtain it, one needs, in principle, no more

[1]Air, for example, is physically of finite supply, but no wants are currently left unmet on account of this. Thus, air cannot qualify as an economic good and in this sense is of "unlimited" supply.

[2]See the preceding references. Kinsella (1996) provides an overview of other such recent work.

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than one's own labor. Cooperation with others is not necessary (though of course it may be preferable to acting alone).

Scarcity as Derived from Ownership

The case is different regarding goods that are owned. Here, interactions with others *necessarily* arise when nonowners seek to put the good to an alternative uses. The owner, presumably, has a just claim over the use of that good, and he alone may decide how that good is put to use. Different property rights regimes may place greater or lesser constraints over the extent of his use, but ultimately the owner determines what will happen to this good. Of course, with a system of property rights there must not only be constraints on how property is acquired, but also on how it is exchanged. Still, what determines the terms on which exchanges of property take place are the desires of property owners on both sides of an exchange.

Because of the fundamental fact of scarcity, a good can be applied to multiple ends, any one of which precludes the others from being realized. In deciding whether to homestead an unowned good (that is, apply one's labor to acquiring the good and so become the just owner), a person must judge whether that choice will best meet his ends. He must then make a further choice as to how the good should be obtained and used. Of course, he must understand the property rules for his society, so that his actions are justifiable, but in this case the only barriers due to scarcity that he faces are the facts that by homesteading the good, he cannot do something else, and that by using the good in one way he cannot use it in some other way.

He of course faces these same difficulties when deciding whether to acquire an *owned* good. However, now he faces an additional problem: namely, how to obtain access to property from which he is forbidden, absent the owner's consent. The scarcity he now faces is distinct from the fundamental or general scarcity that characterizes our world. For under a private property regime, the owner alone decides how available an owned good will be for various purposes. This scarcity stemming from ownership holds across all property. For to obtain someone else's property, I must engage in some kind of exchange with that owner, and this presumably will involve an exchange of property. If, say, owners of beer are demanding $20 a bottle for their product, then if I so desire beer that I will pay this price in money property, my money property likewise becomes scarce to me and I must be quite careful in how I apply it elsewhere. On the other hand, with money prices, I am at least able to coherently apprehend scarcity in this sense, as there exists numerical ratios that allow me to compare prospective actions to anticipated outcomes.

Thus we can see that goods can be considered scarce not only on the basis of the limits of their physical supply relative to wants, but also on the basis of the desires of the owners of those goods. The need for and existence of property stems from a fundamental fact of reality regarding objects as goods—namely, scarcity. However, once a good becomes property, there is a further aspect

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of scarcity that must be considered, and this aspect stems from ownership. Because of scarcity in the fundamental sense, one is forced to make choices. An action made in one endeavor is an action that cannot be made in another. A ton of steel used to make cars cannot be used to make railroad tracks.

Because of scarcity due to ownership, one is forced to take something else into consideration: how to persuade the owner of the good in question to part with it, and this is distinct from the notion of scarcity as reflecting a limited physical supply relative to wants (although, of course, it is ultimately dependent on this fact). Now, the question is not only whether to use steel to make cars versus railroad tracks, but how to obtain the necessary steel from the person who owns it. Depending on the relative ease with which this can be done (that is, how much *other* property must be given in exchange for this steel), one application might be chosen over the other, and it is possible that neither will be feasible. The owner may be so insistent on keeping his property that the only price (in terms of money property) that will change his mind is sufficiently high for an entrepreneur to judge that these goods cannot be profitably applied anywhere. Or, the owner might be sufficiently generous that an entrepreneur will judge a wide range of projects to be feasible. In either case, the good in question is scarce to the extent that the owner wants it scarce.

Property is a means for solving one problem: the fact that prospective means in the physical world are of insufficient supply to meet all our ends, so conflicts with others may arise as a result. Property rights in these means establish boundaries which exclude others from using these means, and so serve as a way of resolving conflicts over them. (Of course, any property rights system, including systems based on the violation of such rights, for example, the State, is only effective to the extent that people are willing to abide by it.) In solving one problem—namely, disagreement over (scarce) goods in a state of nature—property creates another problem: the fact that an owner must now be persuaded to part with his property if one desires to apply that good to some end. However, as a property rights system must provide some way of exchanging validly owned goods, the system permits a solution to this problem: specifically, economic calculation. The amount of property one must surrender to acquire some other property, deemed more important to satisfying one's needs, can be determined in terms of money prices. One can calculate whether the anticipated proceeds from some course of action will exceed the costs required to presumably bring that action about.

So under a system of property rights, economic decision making must take scarcity into account, not only in the usual sense of choosing which wants are to be satisfied with a finite physical supply, but also in the sense that how available a good is depends also on the circumstances arising from that particular good being owned. When a good is owned (and on the free market, ownership implies not just control but the ability to exchange), the notion of a quantifiable amount of property needed to acquire that good comes into existence. This in turn leads to numerical exchange ratios (prices), which are the basis of economic calculation for comparing prospective gains and costs.

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Whether a particular good will be scarce or plentiful relative to a potential use then depends on how much property that good's owner demands for it; the question of how to "best" produce something cannot be answered outside the framework of a property rights system for determining what factors are available (attainable) for its production. Indeed, the availability of factors in an economic sense plays a role in determining *what* should be produced in the first place.

Implications for Economic Decision Making

Under a private property regime, there is a duality: On the one hand, consumers, as property owners, determine what is produced to the extent that producers whose products are unwanted by consumers will soon find themselves out of business. On the other hand, producers, as property owners, determine what is consumed to the extent that they decide to allocate their property to certain production processes. If the owner of some factor of production will not commit that factor to some line of production, those products will not be produced and, hence, not consumed. He may come to regret his decision, but that can only be revealed in the future, not now. The wishes of consumers and the "knowledge" of other entrepreneurs are irrelevant. As Rothbard (1993, p. 561-66) argues, the concept of "consumer sovereignty," if used in any but the above sense, is false.

Attention here must be drawn to the aspect of scarcity that derives from the specific fact of ownership, as opposed to the more general condition that the physical supply of a good is insufficient to meet all wants regarding that good. To be sure, we live in a world where goods exist only in finite physical amounts, so that not all wants can be satisfied. However, a subset of this more general form of scarcity is the scarcity that depends on the subjective valuations and desires of property owners. Whether a good is scarce or plentiful from this standpoint depends on the wishes of the owner(s) of that good.[3] A few pounds of wheat, for example, may be more plentiful than a ton of wheat, if the owners in the former case are extremely generous with their property while the owners in the latter case are extremely covetous of theirs. It is this component of scarcity, and not *only* the general fact of physical scarcity relative to wants, which is relevant for economic decision making. Even to acquire an unowned good from a state of nature requires the concept of self-ownership, such that one can compare the amount of property one would receive by acquiring the good oneself or working in a different line of production. (This leaves aside issues of alienability in ones body compared with physical objects; see Kinsella 1999.)

[3]Of course, if nobody else wants the good in question, then from the point of view of these others, the good is quite plentiful. However, to acquire an owned good requires the consent of the owner, and his desires will determine how scarce the good is for use by others.

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Under a capitalist system, it is largely irrelevant who owns what.[4] More precisely, the functioning of a market does not depend on particular ownership, only on the fact of ownership. As a consumer of beer, it may matter quite a bit to me that the owners of factors that could produce beer are unwilling to devote their resources to such production, thus yielding less beer than (technically) possible. However, with unfettered private property rights (such that valid exchanges are unhindered), there will be no situations of surplus or shortage, where actors cannot adjust prices and where there are willing sellers and buyers, but no willing buyers and sellers, respectively. (Markets "clear," in other words.[5]) It is only important that someone owns a factor of production. In that case, one may compare the anticipated revenues (in terms of money property) from an action with the costs (also in terms of money property) of bringing that action about. Once one has formed a judgment as to how much property consumers will give for some product, one can calculate how much property (in the same units) one can afford to give to acquire the means judged appropriate to produce that good. Regardless of whether a particular factor is owned by a miser or a freewheeling sort, exchange ratios result that permit the meaningful comparison of various actions on the market.

Factors of production are valuable because the output they produce is valuable. But because the outputs of production are subjectively valued, it is not possible to compare outputs with potential inputs on the basis of value. However, under a system of private property in the means of production, numerical exchange ratios (prices) exist which permit precisely this comparison (that is, economic calculation). Whether a factor owner is stingy or generous (so that the price of his factor is "high" or "low") is irrelevant to the fact that economic calculation is the tool of entrepreneurs who must always first form a judgment about the future. Whatever "knowledge" may be "embedded" in the prices in those two different cases in no way changes the fact that, in either case, the factor in question can only be applied to production if an entrepreneur judges that it will be profitable, *and* if he can obtain property sufficient enough to acquire it (Hülsmann 1997). Indeed, the question of whether he can afford this factor determines the profitability of that factor in any given venture. The scarcity induced by ownership is always addressable by economic calculation.

The question of what goods to produce cannot be answered separately from the question of how scarce the factors needed to produce that good are. However, this scarcity is dependent on the ownership of those goods, and not simply on the fact that such resources exist in physically finite amounts. Thus one can never speak of value scales as such for the purposes of economic planning. One must always speak in terms of how much (anticipated) property

[4]Provided, of course, that unowned goods may be homesteaded (that is, unowned goods can become property), and that one can expect such rights to be respected over time.

[5]A "common-sense" equilibrium, as opposed to the general disequilibrium case of unmet desires at any given time, see Gordon (1995).

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consumers are willing to give in exchange for those goods, which, when combined with the amount of property (referred to a common unit) needed to obtain the means for producing those goods, enables one to decide what is to be produced for consumption.[6] Value scales of consumers are only part of the problem. If a particular factor owner will not surrender his property for less than what other entrepreneurs think it can yield in some line of production, then that factor will not be used in such a way, regardless of consumer wishes (or competing entrepreneurs' knowledge thereof).[7]

Predecessors

The notion that the scarcity of a good depends on the ownership of that good is not entirely new. Indeed, an early economist of Austrian bent, Bastiat (1966b, chap. 1), spoke of the subjectivity of scarcity (and its flip side, abundance) when he noted that people have different attitudes toward scarcity depending on what side of a transaction they are on. In fact, property played a key role in his thought. Consider the following passage from Bastiat (1966a, p. 228):

> What I now say, what I declare with conviction as an absolute certainty in my own mind, is this: Yes, there is constant interaction between private property and the communal domain. . . . But the second assertion, amplified and exploited by the socialists, is even more dangerously erroneous; for this interaction does not cause any part of the communal domain to be appropriated into the domain of private property, but, on the contrary, constantly extends the former at the expense of the latter. Private property, inherently just and legitimate, because it always is proportional to services, tends to convert onerous utility into gratuitous utility. It is the spur that impels the human intellect to realize the latent potential of the forces of Nature. It attacks, to its own profit admittedly, the obstacles that stand in the way of gratuitous utility. And when the obstacle is surmounted to any degree, we find that it results in corresponding benefit to all. Then, tirelessly, property attacks new obstacles, and this process continues with never an interruption, steadily raising the standard of living, bringing the great family of man nearer and nearer the goals of community and equality.

There are probably a number of ways to interpret this passage, but its emphasis on the centrality of property in human society is clear. Bastiat clearly recognizes the role property plays as a means toward our ends. However, one can

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[6]In fact, the price of any good depends both on the demand and supply of it, so one can never speak of prices for consumer goods without reference to prices for producer goods. For a discussion of price formation on the market, see Rothbard (1993, chaps. 2 and 3).

[7]Likewise, if factor owners are unable to ask for as much property as they would like to for their products (as is the case under, say, price controls), then they will not do so, and furthermore, prospective buyers of those factors will deem them more plentiful than they actually are. This is another example of the illusions fostered by the property rights violations of the State; see Hülsmann (1998).

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discern (at least, with a broad reading) elements of the role of economic calculation here. For by permitting exchange ratios (Bastiat elsewhere speaks of the necessity of exchange for determining value), individual ownership of property allows all others in society to appraise such property as means for meeting their ends, whereas such an appraisal would be impossible without property. The means available to man without economic calculation are of extremely limited scope; private property enabling such calculation broadens this scope enormously.

Among modern Austrians, it is Rothbard who comes closest to calling explicit attention to this concept in his discussion of monopoly prices (Rothbard 1993, chap. 10). Here, Rothbard notes that the notion of "restrictionist" production (a charge frequently leveled against entrepreneurs in support of antitrust policies) makes no sense on a free market, as the fact of scarcity means that one *always* restricts some production by the simple fact of pursuing one course of action over another. According to Rothbard,

> In the real world of scarce resources in relation to possible ends, *all* production involves choice and the allocation of factors to serve the most highly valued ends. In short, the production of *any* product is necessarily always "restricted." Such "restriction" follows simply from the universal scarcity of factors and the diminishing marginal utility of any one product. But then it is absurd to speak of "restriction" at all.

And in his discussion of the concept of "consumer sovereignty" (pp. 561-66), Rothbard notes the dual role all men play as both consumers and producers, and that the proper conception is one of *self-sovereignty*. The notion that producers serve consumers is true in the sense that producers must make things that consumers want, otherwise they will go out of business. However, it is false in a literal sense, and certainly unjustifiable in an ethical sense.

In the context of a different controversy of relevance, namely the socialist calculation debate, Rothbard (1991) quotes Professor Georg Halm:

> It is true that the central authority would know quite well how many capital goods of a given kind it possessed or could procure. . . .; it would know the capacity of the existing plant in the various branches of production; but it would not know how scarce capital was. For the scarcity of the means of production must always be related to the demand for them, whose fluctuations give rise to variations in the value of the good in question.

It can only be added to this insightful statement that "demand" must be understood to include *reservation demand*, the amount that sellers will withhold from the market (see Rothbard 1993, p. 118). But of course, something can only be withheld on an unhampered market if it is validly owned, so we see again the key role ownership plays in the decision making of all market participants, both of existing owners and prospective owners (that is, nonowners). The scarcity of a factor of production will depend not only on

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the demand for the products it can produce, but also on the judgments and valuations of the factor owner regarding its use.

The key point, the explication of which has been the objective of this here, is that restriction and sovereignty on the market stems from *ownership*, both in the sense of producers as owners of themselves, and as owners of the factors of production which they alone may decide how to best dispense with. In this case, scarcity of both consumer and producer goods is derived from the judgment of property owners. While scarcity is a fundamental fact of our existence, scarcity on that subset of existence, the market, is entirely dependent on ownership. If one wishes to attack a producer on the grounds that he makes his goods scarce, then one must do so on ethical grounds, for by granting him control over these goods, one grants the notion of their availability for production to be a question for him to decide. One cannot speak of consumer goods being scarce without reference to the scarcity of the goods needed to produce them, and this scarcity on the market must ultimately be considered in terms of the ownership of those factors.

We will use the term *catallactic scarcity* to refer to this notion of scarcity that derives from a good being owned, in distinction from the more general fact of scarcity, which we will term *physical scarcity*. Of course, physical scarcity is understood to have an economic component of its own, specifically the limitation of means relative to ends. However, we make the distinction to call attention to the ownership-dependent aspects of scarcity. By understanding catallactic scarcity as inseparable from ownership, we can turn attention to applying this concept to several current debates in Austrian economics.

Application I: Economic Calculation and Socialism

The comparison of prospective gains with potential costs as a criterion of economic decision making has been referred to as economic calculation (Mises 1998, chap. 12). It was Mises who put forward the argument over seventy years ago that economic calculation is impossible under socialism, and that such an economic system is therefore not rational (Mises 1990; 1998, chap. 26). There has recently been a debate within the Austrian School over what, precisely, this argument means, with some researchers taking the position that the argument refers to the absence of private property, such that exchange ratios permitting computation of profit and loss are impossible (for example, Herbener 1991; Salerno 1993; Hoppe 1996); others interpret it as meaning that information conveyed by prices does not exist under socialism, such that opportunities for profit go unrevealed (for example, Kirzner 1996 and Horwitz 1998). These two camps may be called, respectively, "Misesian" and "Hayekian."[8]

[8]The neoclassicist position seems to be sympathetic to the Hayekian interpretation, see Yeager (1994). See also, among others, Hülsmann (1997) for a detailed analysis of these issues.

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It is not the purpose here to enter into this debate. However, some support will be given for the Misesian framing of the argument by highlighting the centrality of privately owned property to economic decision making, and we will now turn to this topic.

Under socialism, of course, there is no private ownership of the means of production. Thus, the notion of scarcity in an *economic* sense has no meaning in such a system. A socialist planner may have complete knowledge of the *physical* amounts available to him, and all the ways to use them, but this is irrelevant for the purposes of economic planning. For this, he must have some knowledge of a factor's catallactic scarcity, but this is entirely dependent on that factor being owned (so that exchange ratios may be formed). This "knowledge," however, does not refer to some physico-chemical property of the good that could be "conveyed" to him through a price system. Rather, this knowledge refers to no more than being able to determine how much property he must give to acquire the good, which will then constrain what kind of consumer goods he can create with it. Under different patterns of ownership, this kind of catallactic scarcity will change, so there is in fact nothing objective the planner *can* know about. But when the factor is owned, prices for economic calculation can *always* be formed. Without any notion of catallactic scarcity of the means of production (which depends on ownership, not knowledge[9]), there can be no notion of what consumer goods are economically feasible.

What does not exist without private property (however incompletely attenuated) is a means for objectively comparing different courses of action, *given* a judgment about the future. At most, prices inform about how much *property* must be given *now* to acquire a particular factor of production. They tell nothing about how to use that factor or whether the future will prove some such use fruitful or not. Entrepreneurial judgment is required for this, and if some factor owner will not surrender his property for less than an entrepreneur thinks its products can be sold for, that factor will not be so used. It is ownership, not knowledge, that determines the status of the factor (Hülsmann 1997).

Thus, in a socialist economy, it is not enough to know (however completely) available physical amounts of resources and technologies for combining them along with consumer value scales. To speak of an action being economically "efficient" or rational requires being able to meaningfully compare inputs and outputs. One must be able to quantify what consumers will be willing to give in return for the outputs of production, and similarly relate the inputs of production to the same "standard." However, it is clear that no such thing can be done in a socialist state, where there can be no ownership in the means of production, and so notions like catallactic scarcity (and resulting

[9]Property and knowledge are not the same thing, and unlike property, knowledge itself can never be scarce in any sense. That I have an idea in no way precludes someone else from having that idea, while ownership arising from scarcity does imply such exclusion (Kinsella 2001).

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exchange ratios in terms of other property) are meaningless. It makes no sense to speak of how much property can be given in exchange for socialized factors of production, so it likewise makes no sense to speak of what products should be produced for consumption, as the ability to consume depends on the ability to produce. Knowing consumer preferences is of no use in solving this problem.

Socialism thus severs the duality between consumption and production, and this is its fatal flaw, not an absence of knowledge that could be conveyed by prices. (The equations of neoclassical economics explicitly make this dichotomy and consider only the physical scarcity of resources for production, and so are of no use for economic planning, even apart from knowledge problems and their static nature.[10]) To be sure, it has never been demonstrated how this transmission of knowledge through prices supposedly occurs, or exactly what information, "tacit" or otherwise, is contained in prices, but the point is that under a private property system, it is irrelevant whether someone "knows" of great, unmet demand toward which some factor of production can be applied. On the free market, such a factor is presumably owned, and unless that owner is willing to part with his property (which requires an exchange of other property), that factor cannot be applied to that production process, regardless of how much knowledge one possesses of alternative uses for it.

Also, one wonders where the importance of "decentralized" knowledge lies (see Hoppe 1996). For ownership is both centralized and decentralized: centralized in the fact that one and only one person controls access to some good (even when the good is jointly owned, different people own different shares), and decentralized in the fact that under a private property regime (either free or partly free), *anyone* can attempt to acquire the good by offering sufficient property in exchange. Indeed, at what stage does "economic knowledge" become decentralized? When, say, ownership of some physical supply is more or less evenly distributed? Why not when a single person owns 99 percent of a good? In either case, prospective actions can be coherently

[10]All of these equations in their various guises essentially try to "maximize" utility subject to physical and technological constraints on available resources. Even granting that, with complete knowledge and perfect foresight, a planner could allocate resources for a given period based on these equations, the question of how much of his available resources he should hold in reserve for future consumption cannot be so addressed. At some point a planner must stop cannibalizing an existing capital structure and at the very least maintain that structure, so capital goods must be included in his value scale. However, it is nonsense to include indirectly valued means among his directly valued ends. Even means must be economized, but unlike ends, recourse to their utility is futile for doing so. They only have utility because of the (direct) utility of the ends they produce, but it is only the utility of ends that one may appraise, in terms of the wants they remove. Only monetary prices permit the appraisal of both means and ends. The choice of how to "model" available means in these equations is arbitrary at best, if not absurd (for example, modeling capital "growth" like some sort of natural phenomenon). Thus, as Salerno (1990, p. 56) noted, "[s]ocialism will have particularly devastating effects on the economy's capital structure."

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evaluated ("appraised") via economic calculation. It is the existence of markets that permits economic calculation, not the decentralization of knowledge, economic or otherwise.

One may concede, however unlikely, that a socialist planning board may have complete knowledge of resources, technologies, and tastes, and may be able to assemble factors to produce some list of desired goods. However, this output has no economic meaning because there is no notion of exchanging one state of affairs for another, of sacrificing consumption to production and vice versa. One may contend that the central planning board could not "know" whether a particular allocation of resources is economically efficient, or whether they are meeting some needs at the expense of other, more urgent needs. However, these objections only make sense within the context of ownership of the goods and resources in question. However, it is pointless to exchange property for production purposes based on subjective valuations, and economic calculation with market prices (exchange ratios) permits the subjective valuations of consumer goods to be *indirectly* imputed to producer goods. But again, it is ownership and not knowledge that is central to this process, for only ownership enables the exchange ratios necessary for this comparison process to come into being.

What are economically wasteful inputs under one realization of private property rights may be profitable under another realization, depending on the desires of property owners, both from the point of view of producers as well as consumers. Correspondingly, a different set of outputs (consumer goods) will be economically rational or irrational, depending on these circumstances. Under such a system, it only makes sense to speak of less urgent needs being met if an entrepreneur obtains a loss on his venture. With different patterns of ownership, that venture may well prove profitable, in which case one would say he has met urgent needs. One cannot say, for example, that it is always economically wasteful to build a car with gold. It is only under *current* conditions (of ownership, valuations, etc.) that such an activity is wasteful. Under different conditions, it may well be profitable.

So, the problem with socialism is not that the central planning board will not know how to best meet given ends. It is that without the notion of privately owned means of production (and hence catallactic scarcity of those means), the notion of *what* ends are appropriate at all makes no sense. One may postulate a "market" for consumer goods in a socialist state, with "prices" for these goods. However, these prices have no relation whatsoever to their counterparts in a capitalist state, even if numerically they should happen to be the same. For the prices in a capitalist system imply an amount of property that can be given in exchange for that good. In a capitalist system, this (money) property encompasses consumer as well as producer goods. Obviously, whatever property can be obtained in a socialist economy must exclude producer goods, so the notion of "prices" as exchange ratios, even among consumer goods, is severely restricted if not meaningless.

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Application II: Monopoly Capitalism

Of course, it may be objected that, even under socialism, catallactic scarcity also exists, as the central planning board *does* in fact own the means of production in the society under its control. However, this is better characterized as *controlling* these factors, as ownership suggests that one can divest oneself of property, and of course this cannot happen under socialism (if the system is to remain socialistic). A contrast may be made with the situation of monopolies under capitalism. Under capitalism, a person may be the sole owner of some particular factor or class of factors. In principle, however, one can always offer such a person property in exchange for these factors, so there is a notion of scarcity in the sense of what uses these factors can be profitably put to, relative to what must be used to first acquire them. Such a situation cannot, even in principle, occur under socialism. Indeed, we again see the duality of exchange that exists under a private property system. To own something means that someone *else* must surrender a certain amount of property in order to become the owner. How much property depends on the valuations of the prospective exchangers. Even a "monopolist" can in principle be persuaded to part with his goods, and an entrepreneur can at least attempt to calculate how much this will take. Such an endeavor may prove fruitless, but it is at least possible. (Likewise, if no one has any interest in or anticipates any profitable use of the monopolist's goods, then the fact that he is sole possessor poses no problem for entrepreneurs.)

So even an extremely restrictive monopolist faces a categorically different situation than the director of the central planning board. The monopolist can in principle transfer ownership (for a price), while the director cannot. The extent to which the monopolist is willing to do so determines the scarcity (economic) of his factors, and thus what is feasible to produce for consumption. Whether the director would be generous or covetous is irrelevant; neither characteristic changes the fact that he cannot dispose of these goods, so attaching economic significance to them is impossible (or, better, meaningless), unlike under a private property system. Furthermore, from an economic perspective, the monopolist, as an owner, behaves no differently if he restricts use of his factors or applies them. In either case, his subjective valuations and judgment of how best to satisfy himself drives his actions. This aspect of economic behavior, either committing or withholding resources, is the dual part of every economic action under private property. For the director, it makes absolutely no sense to speak of him withholding resources. For what end? For the director, he *must* apply these resources, so the notion of catallactic scarcity which implies the need to conserve resources is absent. Again, the duality between production and consumption is severed under socialism.

Even if an entrepreneur should happen to come into ownership of all the means of production in some society, his position is quite different from that

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of the director of the central planning board under socialism. The monopolist can always assign economic significance to his property by entertaining bids from others, and of course he can accept those offers. In a capitalist society, money prices encompass both consumer and producer goods. For the central planner, it is absurd to think he can receive bids for the property under his control. He *cannot* exchange his property, so any attempts by him to "play" market are just that: meaningless games.[11]

Should the monopolist actually refuse all offers, he can still in principle accept them at any time. And in fact it is his stance that determines the notion of catallactic scarcity in his society. For assuming he came about his goods justly (that is, mixed his labor with unowned land or acquired, through voluntary exchange with others, property likewise created (Hoppe 1989, 1993; Rothbard 1998), then there can be nothing wrong in an ethical sense with him hoarding all of his goods. (Of course, socialism violates the "natural" property rights of others, and this alone would disqualify socialism as a justifiable system, but this is a separate issue.) Whether his hoarding, which would presumably lead to great suffering for others, is wrong in a moral sense is an entirely different matter. In this case, the scarcity in society is quite extreme—one might say far "greater" than the mere fact of limited physical amounts.

The director of the central planning board is in no such position. The notion of him accepting or refusing an offer for his property (so that numerical *exchange* ratios for economic calculation could be formed) is absent under socialism. Any bid he could receive would be meaningless, for he cannot surrender any factor of production. Under capitalism, the bids made to factor owners, be they monopolists or not, permit the evaluation of prospective actions. That is, prospective gains can be meaningfully compared with costs because a common unit of comparison exists. No such common unit exists under socialism. Even a monopolist can coherently compare the gains from applying a factor to production himself or selling it to someone else. The socialist director cannot sell a factor. Single ownership of a good does not abolish markets for that good, so prices can still be formed. Coercive socialism, however, *does* abolish markets.

Application III: Business Cycle Theory

As a further, albeit brief, application of the concept of catallactic scarcity as determined by ownership, consider Austrian business cycle theory. The details of this theory need not be expanded upon here, and some familiarity will be

[11]More generally, as states may be considered territorial monopolists of judicial and protective services, one can make a distinction between privately owned governments, such as monarchies, which can engage in economic calculation, and publicly owned ("caretaker") governments, such as democracies, which cannot. For more on this distinction, see Hoppe (1999).

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assumed (for example, Rothbard 1983; Mises 1998, chap. 20). The main thrust of the theory is that economic downturns ("recessions") are attributable to the fact that credit inflation distorts the structure of production, which depends on the time preferences of consumers (their willingness to forego current consumption in favor of future consumption). Thus, "artificially" low interest rates give rise to a (lengthened) structure of production inconsistent with the (unchanged) time preferences of consumers, necessitating at some point a restoration of the original structure (a boom-to-bust process).

Certain aspects of this theory have been criticized by Hülsmann (1998), in particular the notion that downturns are the *consequence* of credit inflation. (Hülsmann accepts the descriptive details of the nature, but not the cause, of the cycle as laid out by Austrian business cycle theory.) Among other points, he argues that inflation, like any other unanticipated change, can be correctly forecast by entrepreneurs, so there is no reason to presume that they will be so misled. (This is actually, in one form or another, a common critique of the theory.) Austrian business cycle theory in its usual form is at best, then, a contingent theory of economic downturns. Instead, he argues for an *essentialist* rendition of Austrian business cycle theory, wherein error is not a consequence of past conditions (no such consistent theory is possible), but rather is inherent in the system of banking that exists today throughout the Western world (that is, fractional reserve banking, the lending out of demand deposits in excess of reserves).

Some support will be given here for Hülsmann's argument. First, it should be noted that, on a free market, it is consumer time preferences that determine the length of the structure of production. The more consumers are willing to save (that is, forego current consumption in favor of future consumption), the more far-removed or "round-about" production processes can be relative to the finished product.[12] That is, the *scarcity* of capital goods in an economic sense is determined by ownership, namely the willingness of consumers to exchange their current property for future claims to property. This property can then become owned by entrepreneurs, who can assemble a structure of production as described above (that is, via judgments and economic calculation). Whether the consumers directly give their property to entrepreneurs or (more likely) use banks as an intermediary is irrelevant. The key point is that the availability of capital goods again depends on private property (ownership).

The situation is quite different under a system of fractional reserve banking. Here it is not property and the subjective valuations of its owners that determine scarcity (in the economic sense) and drive production processes. Rather, it is the ability of banks to create *titles* to property not backed up by actual property.[13] That is, catallactic scarcity, which depends on the ownership of property, is not the determinant of production (and thus, ultimately,

[12]See Rothbard (1993, chap. 8) for a more detailed discussion of this process.

[13]See Hoppe et al. (1998) for more on this point, as well as the purely juridical nature of fractional reserve banking.

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consumption). Instead, the catallactic scarcity of capital goods is *inherently* misrepresented under this system, as the bankers do not surrender their own property in exchange but rather create "false" property, claims to property divorced from existing property. It thus *appears* that more property is available for production than actually exists, and here is the nature of the crisis as laid out by Austrian business cycle theory–the mismatch between consumer time preferences and entrepreneurial judgments thereof.[14]

Indeed, one may refer to this situation as a "political discovery process," as distinct from a fallacious "price" discovery (Hülsmann 2000), since the availability of capital is not determined by the value judgments with property of individual owners, but by the ability of bankers to discover how much they can jointly issue titles to property in excess of actual, existing property. That is, the scarcity of capital is not determined by the subjective valuations of the *owners* of capital, whether they are generous or greedy with their property. Rather, the amount of capital is determined by the actions of *others*–in this case, other bankers. The more other bankers expand their lending beyond reserves, the greater latitude any other banker has for doing the same. This situation does not result when considering individual property owners, where the decision to make property available is entirely up to the individual owner. In fact, the entire concept of property *at all* is distorted under fractional reserve banking, for in this case what constitutes "property" is dependent on the will of the bankers to create something out of nothing. Under a true property regime, one cannot create something out of nothing, regardless of the intensity of one's desires. This is not true under fractional reserve banking, where the only constraint on any individual bankers desires is the extent to which other banker's are likewise willing to inflate.

Thus the notion of scarcity of capital goods (and the resultant production structure based thereon) is completely blurred under fractional reserve banking, and it is the nature of the system that is the ultimate source of the error (malinvestments) and that Austrian business cycle theory attempts to explain. To be sure, the concept of catallactic scarcity is not completely obliterated, as it is under full-blown socialism. It remains the case, though, that the scarcity of capital is falsely represented under fractional reserve banking.

Conclusion

To conclude and summarize, the notion of scarcity of a particular good for economic purposes must include reference to the *ownership* of that good, and not just the limited physical amount of that good relative to wants. It is scarcity in this economic sense (that is, the willingness of the owner of some good

[14]To use Hülsmann's (1998) term, the illusion of more property is created by fractional reserve banking. More generally, as an inherently aggressive institution, the State relies on many other illusions to continue its existence, for example, the illusion that people can remain owners of themselves and their property while granting the State the ability to unilaterally tax, jail, etc.

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to exchange it for something else) that is of central importance to economic decision making (calculation, comparing anticipated revenues with prospective costs in a common denominator), both in deciding *how* to produce something, as well as *what* to produce. One cannot hope to reproduce the results of an unhampered market with systems that destroy the central characteristic of that market. Various forms of violent intervention in the market abolish this crucial notion of scarcity, either completely, as under socialism, or partially, as under fractional reserve banking, with results that are, at best, arbitrary from the point of view of consumers. In actuality, of course, the realized results have been utterly disastrous.

It is not a question of "knowing" how valuable ones actions can be, and learning of this through the price system. The point is that action within society is always action within a system of property rights, restricted or unrestricted to some degree. Given constraints on our actions as imposed by such a system, the question becomes, what must one do to attain one's goals? In a system of property rights, one must exchange property for property, based on judgments of the future. Only under a system of property rights can one quantify and compare in a common unit gains relative to losses (comparison of procedures for producing subjectively valued goods being otherwise impossible), and only under a system of *unfettered* property rights is the duality between consumption and production preserved. That is, only then are there objective constraints on both what is produced and consumed. Social democracy and state capitalism as currently exist in the Western world blur this duality, while complete socialism demolishes it.

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The Impact of Transfer Payments on Economic Growth: John Stuart Mill versus Ludwig von Mises

Lowell Gallaway and Richard Vedder

In this article we examine the differences between two prominent economists who lived about a century apart in time. In the nineteenth century, there was John Stuart Mill (1806-1873) who offered (in his *Principles of Political Economy*, bk. 2, chap. 1) the following assessment of the relationship between the phenomena of production and distribution:

> The laws and conditions of the production of wealth, partake of the character of physical truths. There is nothing optional or arbitrary in them. . . . It is not so with the Distribution of Wealth. That is a matter of human institutions solely. The things once there, mankind, individually or collectively, can do with them as they like. (pp. 257-58)

This is a somewhat mechanistic (and simplistic) exegesis of the production-distribution linkage. However, it is one with profound implications for public policy. What it suggests, particularly where collective action is concerned, is the possibility of a social "taking" of wealth (or income) from some to be then disbursed to others considered to be more deserving. According to Mill, such a redistribution process would be a zero-sum game, having no impact on the overall production of wealth (national income).

There are obvious reasons to be suspicious of Mill's premise. Written in the era that it was, it suffers from the lack of perspective that would later be provided by the marginalist interpretation of the conditions surrounding the employment of factors of production, especially labor. In the case of labor inputs, Mill performs the obligatory obeisance to demand and supply forces, but lurking in the background is some form of *deus ex machina* that attenuates any link between labor productivity and the level of wage rates. Sometimes, it is a wages-fund notion. Sometimes, it is Malthusian pressures. Whatever, these

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THE QUARTERLY JOURNAL OF AUSTRIAN ECONOMICS VOL. 5, NO. 1 (SPRING 2002): 57-65

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external constraints raise the specter of "low" wages. Mill devotes a twenty-nine-page chapter (bk. 2, chap. 12) to the "low"-wage question.

Ultimately, Mill's conception of the link between production and distribution provides an argument for social intervention in distributional outcomes, either through market devices, particularly labor unions, or through public charity that takes the form of income transfers from the more to the less affluent. The syllogism is simple. Actual distributional outcomes are rendered unsatisfactory by natural constraints, but they may be corrected by public policy at no cost to total national output. Therefore, it is appropriate to engage in income redistribution strategies. In reality, what Mill propounds is nothing but a precursor to Marx's *Capital* (1867).

Move forward a century, from Mill in 1848 to Ludwig von Mises's *Human Action* (1998). The opening paragraphs of chapter 32 effectively sum up the Mill-type argument, to wit:

> Interventionism is guided by the idea that interfering with property rights does not affect the size of production. The most naïve manifestation of this fallacy is presented by confiscatory interventionism. The yield of production activities is considered a given magnitude independent of the merely accidental arrangements of society's social order. The task of government is seen as the "fair" distribution of this national income among the various members of society.
>
> The interventionists and the socialists contend that all commodities are turned out by a social process of production. When the process comes to an end and its fruits ripen, a second social process, that of distribution of the yield, follows and allots a share to each. The characteristic feature of the capitalist order is that the shares allotted are unequal. Some people—the entrepreneurs, the capitalists, and the landowners—appropriate to themselves more than they should. Accordingly, the portions of other people are curtailed. Government should by rights expropriate the surplus of the privileged and distribute it among the underprivileged.

Mises then goes on to deny explicitly the basic interventionist premise, saying:

> in the market economy this alleged dualism of two independent processes, that of production and that of distribution, does not exist. There is only one process going on. Goods are not first produced and then distributed. There is no such thing as an appropriation of portions out of a stock of ownerless goods. The products come into existence as somebody's property. If one wants to distribute them, one must first confiscate them. It is certainly very easy for the governmental apparatus of compulsion and coercion to embark upon confiscation and expropriation. . . . But capitalism cannot stand such . . . predatory raids. Its capital accumulation and investments are founded upon the expectation that no such expropriation will occur. If this expectation is absent, people will prefer to consume their capital instead of safeguard it for the expropriators. *This is the inherent error of all plans that aim at combining private ownership and . . . expropriation.* (Mises 1998, pp. 800-01; emphasis added)

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What Mises's views translate into is the notion that a socially engineered process of income redistribution is not the zero-sum game imagined by Mill and the interventionists, but is, in reality, a negative-sum game. Government efforts that take income from the relatively affluent and redirect it to those at the low end of the income distribution will lead to a reduction in total production.

Which View Is Correct?

The remainder of this article will be devoted to assessing the correctness of these two contrasting viewpoints. We begin by recognizing the recent emergence of a substantial literature that is highly consistent with Mises's views on the impact of the confiscatory activities of government on levels of total output. The level of government predation can be measured either by its spending or by its actual tax collections.[1] One of the more notable works along these lines is that of Charles Ballard, John Shoven, and John Whalley (1985), who estimate the deadweight costs of taxation in the United States using simulations generated by a computable general equilibrium model. They find that, at the margin, the deadweight losses lie somewhere between twenty and fifty cents per additional dollar of taxation. Similar conclusions are reached by Martin Feldstein, dealing with the special case of Social Security imposts, in two National Bureau of Economic Research papers (1995 and 1996). Also worth noting on the tax side are the works of Gerald Scully (1988, 1992) and of James Gwartney and Randall Holcombe (1998).

As to spending-measure analysis, our own work (Gallaway and Vedder 1995; Vedder and Gallaway 1998) is strongly consistent with the tax-oriented studies. Our 1995 piece found a marginal deadweight loss of output associated with federal government spending of thirty-eight cents on the dollar, midway in the range of tax impacts estimated by Ballard, Shoven, and Whalley. The methodology used in this analysis is of the more conventional econometric variety.

In summary, a range of scholarly studies using different measures of the impact of government activities and a variety of statistical methodologies reaches conclusions that are strongly consistent with the Misesian perception of the effect of government actions on the total level of economic activity in an economic system.

---

[1]Spending levels probably are the more appropriate. They are a more precise indicator of the distortion of resource utilization patterns generated by government activities in that they include those financed by means other than tax revenues. However, even the spending measure is incomplete in that it does not capture the cost of government regulations, variously estimated to amount to several hundred billion dollars (Hopkins 1996).

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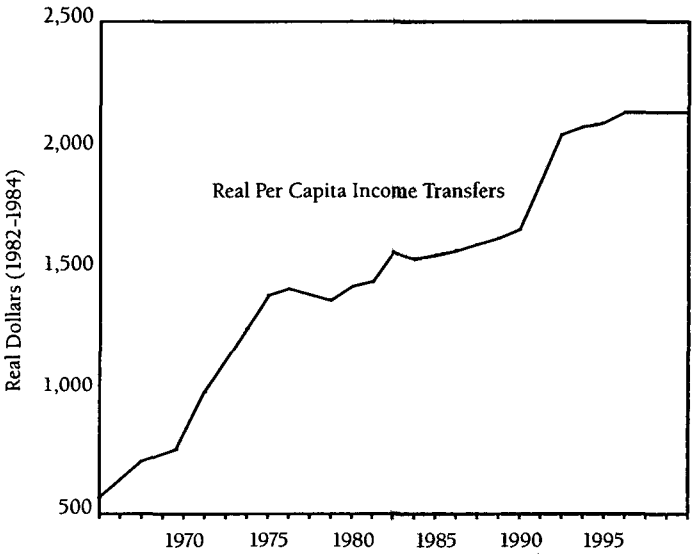
Some Simple Statistics

At this point, we propose to narrow the focus of our inquiry to the specific question of how government attempts to redistribute income by taking from some and giving to others affect total levels of output. To set the stage for a subsequent, more formal analysis of the Mill-Mises dichotomy, as it applies to the United States, some simple statistics are useful. We focus on the third of the twentieth century beginning with 1966 and concluding with 1998.[2] We turn first to the matter of the level of income transfer payments in the United States. From the National Income and Product Accounts (NIPA) data, we have calculated the real level of income transfers per capita over the period in question.[3] The results are shown in Figure 1. Observe that over the thirty-three year span of time real income transfers per member of the population have increased by more than three-and-one-half fold (from $589 to $2,165 in 1982-84 dollars). Also, the pattern of their growth has been quite variable. Initially, there is a relatively rapid increase in such transfers. This continues on into the mid-1970s, to be followed by a more than decade-long substantial slowing in their growth. Finally, in the late 1980s and the 1990s, there is a reacceleration in the increase in real income transfers.

Figure 1
Real Per Capita Income Transfer Payments
United States, 1966-1998



[2]Data for 1999 are available. However, they are less reliable due to the likelihood that they subsequently will be revised by the data collecting authorities.

[3]Real transfer payments per capita are calculated by dividing total transfer payments by population and deflating the result using the Consumer Price Index for Urban Consumers (CPI-U). In that index, 1982-84 = 100.

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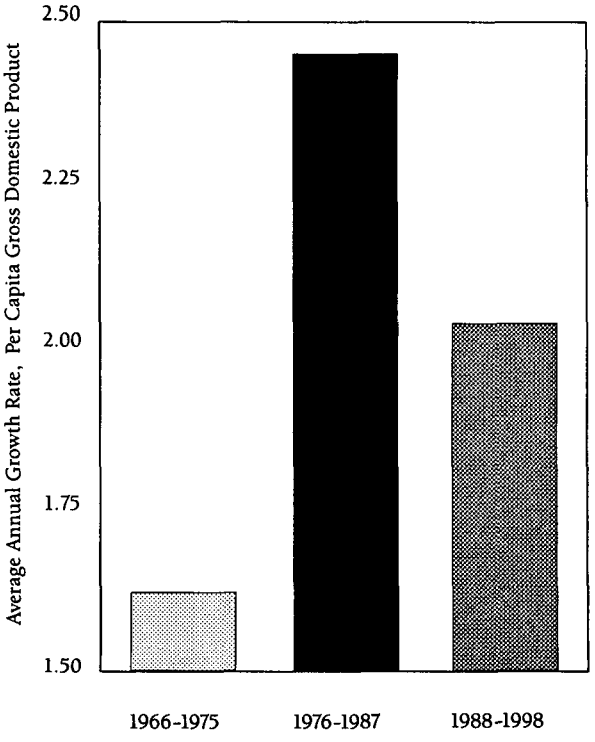
The pattern of movements in levels of growth in transfer payments in the United States closely parallels (albeit in a negative fashion) variations in the rate of growth in real per capita gross domestic product (GDP). Between 1966 and 1975, when transfer payments were surging, real output per head rose at an average annual rate of 1.61 percent. However, over the interval 1976-1987, when the increase in transfers slowed markedly, the rate of growth in real per capita GDP accelerated to 2.44 percent a year. Finally, in the period 1988-1998, when transfer growth burgeoned once more, the output growth rate fell back to 2.04 percent. Figure 2 illustrates these changing per capita GDP growth percentages.

A More Detailed Analysis of the Data

These cursory statistics further support the Misesian perception of the production-distribution linkage. Also, they suggest a need for a more in-depth empirical analysis. We have conducted such an examination using multiple regression techniques, with real per capita GDP as the dependent variable and with real per capita income transfers, the average productivity of labor, and the

Figure 2
Average Annual Growth Rate, Real Per Capita
Gross Domestic Product, United States
1966-1975, 1976-1987, and 1988-1998



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unemployment rate as independent variables. Data from the years 1966-1998 are used. Two different versions of a multiple regression equation have been estimated, one using levels of the variables and the other employing changes in them. A few comments concerning the average productivity of labor and unemployment variables are in order. The productivity measure is designed to control for long-term trends in growth in output per head. On the other hand, the unemployment rate is used to take into account cyclical variations in output.

The statistical results of the analysis are shown in Table 1. Basically, they confirm the aggregate data patterns. The income transfer variable is statistically significant with a Misesian negative sign. In the levels regression, over 99 percent of the variation in the real per capita output variable is explained.[4]

Table 1
Regression Analysis: Explanation of GDP 1966-1998

Regression Statistics			
Independent Variable	Coefficient	t-Statistic	Probability
Panel A: Dependent Variable: Real Per Capita GDP			
Real Per Capita Income Transfers	-1.69	2.22	0.0354
Average Productivity of Labor	198.10	9.16	0.0000
Unemployment Rate	-337.32	9.08	0.0000
Panel B: Dependent Variable: Change in Real Per Capita GDP			
Change in Real Per Capita Income Transfers	-2.03	2.69	0.0134
Change in Average Productivity of Labor	161.24	9.01	0.0000
Change in Unemployment Rate	-330.13	8.71	0.0000

Other regression statistics:
Panel A: Adjusted $R^2 = 0.9992$; ARIMA Scheme (1,0).
Panel B: Adjusted $R^2 = 0.9343$; ARIMA Scheme (0,0).

[4]Some econometric observations are in order. In any time-series analysis, the issue of the stationarity of the variables arises. To explore this, we have calculated Augmented Dickey-Fuller statistics for the dependent variables and the transfer payment variables. In

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The changes (or first-difference) regression is equally powerful, explaining 93 percent of the changes in real GDP per capita. Again, the transfer payment variable is statistically significant with a negative sign. Thus, both of these regression equations confirm the Misesian insight and contradict Mill's vision.[5] In the interest of sensitivity considerations, one other version of the regression model has been estimated. In it, the income transfer measure is transfers as a percentage of GDP. The statistical results are very similar to those observed in the other regression results.

Deadweight Loss Estimates

The regression results reported in Table 1 indicate a statistically significant negative effect of real income transfers on per capita economic growth. But, how strong is this effect quantitatively? To explore this issue, we have developed two different estimates of the quantitative loss of real output per person in 1998, arising from the presence of income transfers in the American economy. The first employs an indirect method, which consists of applying the per capita growth rate for the low transfer payment growth era, 1976-1987, to the entire period 1966-1998, creating a simulated real growth data set. Such a series is presented graphically in Figure 3, where it can be contrasted with the actual real-output-per-capita data set. By 1998, the annual loss per person is estimated at $4,110. At this time, income transfers per head amount to $2,165. Therefore, on average, the estimated costs, or deadweight losses, associated with an additional dollar of income transfers are $1.90 in 1998.

This may seem to be a large value. However, it is consistent with the direct estimates provided by the regression coefficients already reported. In the levels regression, the coefficient is -1.69, indicating that an additional dollar of income transfers reduces output per head by $1.69. In the first difference form of the regression, this coefficient is -2.03. The average of the two coefficients is -1.86, very close to the -1.90 calculated from the output growth data.

Conclusions

Our analysis shows that Mises's critique of "confiscatory interventionism" is the appropriate paradigm for interpreting events in the American economy

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the levels regression, the test statistic for real per capita gross domestic product exceeds the Mackinnon critical value at the 1-percent level while the statistic for real per capita income transfers is equal to the Mackinnon value at the 10-percent level. In the first difference regression, the statistics for both the change in real per capita gross domestic product and change in real per capita income transfers variables exceed the Mackinnon value at the 5-percent level. Thus, there are no serious stationarity problems.

[5]Some additional econometric detail is appropriate. A variety of diagnostic tests have been performed. The regressions reported here pass standard serial correlation (LM) and heteroskedasticity (White) tests. In addition, they pass Ramsey Reset model specification tests and the Recursive Residuals, Cusum, and Cusum Squares model specification tests. Details will be provided by the authors on request.

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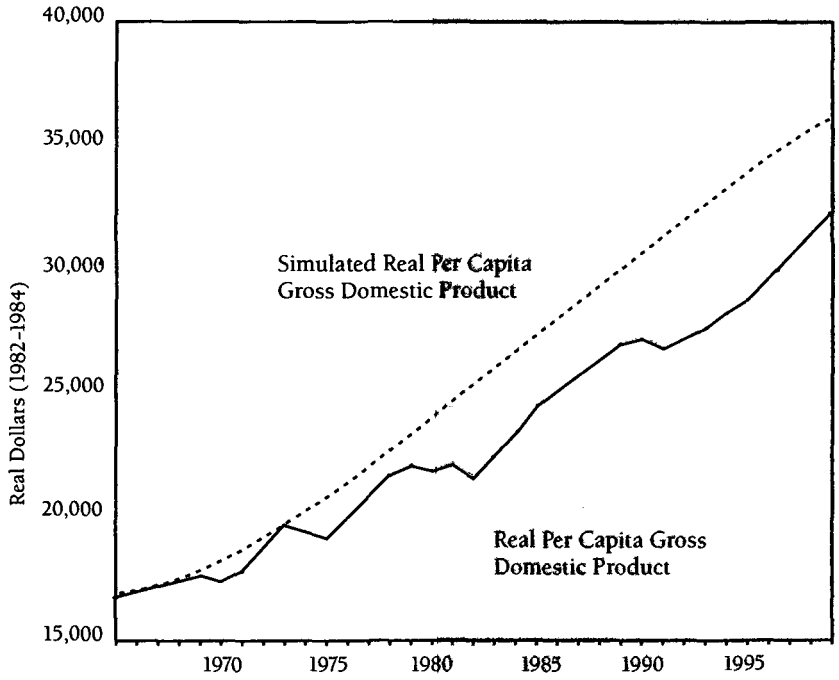
Figure 3
Real Per Capita Gross Domestic Product and
Simulated Real Gross Domestic Product,
United States, 1966-1998



during the last third of the twentieth century. As the "transfer state" has grown in scope, the cumulative deadweight losses to the economy have increased until, during the bulk of the decade of the 1990s, they have driven real per capita levels of output to levels that are about one-eighth below what they might have been. Losses of this magnitude are quite inconsistent with the popular view held in significant political circles to the effect that government activity of the tax and transfer variety is, at its worst, a zero-sum game. This is a position popularized by Lester Thurow (1980) in his book *The Zero-Sum Society*.

Why do losses of this sort occur? Mises (1998) answers that question on page 803 of *Human Action* where he points out that economists ask, "what are the effects of confiscatory taxation on capital accumulation?" His answer says it all: "The greater part of that portion of the higher incomes which is taxed away would have been used for the accumulation of additional capital." Without that capital, economic growth slows, and the deadweight losses mount. Enough said.

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LUDWIG VON MISES ON THE GOLD STANDARD AND FREE BANKING

JEFFREY M. HERBENER

George Selgin and Lawrence White have sought to tie their modern free banking school to the views of Ludwig von Mises.[1] In a recent article, Selgin has attempted to state, critique, and improve upon Mises's defense of the gold standard, while White, in a contribution to a *Festschrift* for Hans Sennholz in 1992, has attempted to demonstrate that Mises favored fractional-reserve free banking (Selgin 1999; White 1992). Whatever the validity of their own views on the gold standard and fractional-reserve free banking, their assessments of Mises's positions on these issues are dubious.

THE IDEAL MONETARY SYSTEM

Selgin begins by claiming that "contrary to the impressions conveyed by some of his followers, Mises did not defend the gold standard on ideological or moral grounds"; but instead "Mises defended the gold standard . . . because he was convinced that a managed fiat money would prove less stable than gold." Selgin then seeks to show "how Mises's argument involves a peculiar and unsatisfactory blend of consequentialism and strict a priori reasoning." On the consequentialist branch, Selgin claims that "his case for gold was based in large part upon his denial of the possibility of measuring, even approximately, money's purchasing power." And on the *a priori* branch, asserts that Mises failed "to make a convincing a priori case for the gold standard" by arguing "that disagreements concerning the direction and extent of changes in money's purchasing power must render a managed fiat money a

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[1]One example is their aptly entitled article, "In Defense of Fiduciary Media–or, We are Not Devo(lutionists), We are Misesians!" (1996).

THE QUARTERLY JOURNAL OF AUSTRIAN ECONOMICS VOL. 5, NO. 1 (SPRING 2002): 67–91

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plaything of politics" and thus less stable than the gold standard (Selgin 1999, pp. 259-60).

According to Selgin, the ideal monetary system for Mises permits changes in money's purchasing power from the goods side, that is, from changes in demands for and supplies of goods, but not from the money side, that is, from changes in demands for and supplies of money. Quoting Mises, Selgin writes:

> While recognizing that the more popular ideal was that of a money "whose objective exchange value is not subject to any variation at all, *whether originating on the money side or on the commodity side*" (emphasis in original), Mises held "a money with an invariable exchange value, *so far as the monetary influences on its value are concerned*" (emphasis added) to be the ideal "of enlightened statesmen and economists." (1999, p. 262)

Selgin, however, is mistaken in asserting that Mises agreed with these enlightened statesmen and economists. To the contrary, Mises found fault in both the "popular" and the "enlightened" views. Concerning the latter, Mises wrote:

> The ideal of a money with an exchange value that is not subject to variations due to changes in the ratio between the supply of money and the need for it . . . demands the intervention of a regulating authority in the determination of the value of money; and its continued intervention. But here immediately most serious doubts arise from the circumstance, already referred to, that we have no useful knowledge of the quantitative significance of given measures intended to influence the value of money. More serious still is the circumstance that we are by no means in a position to determine with precision whether variations have occurred in the exchange value of money from any cause whatever, and if so to what extent, quite apart from the question of whether such changes have been effected by influences working from the monetary side. Attempts to stabilize the exchange value of money in this sense must therefore be frustrated at the outset by the fact that both their goal and the road to it are obscured by a darkness that human knowledge will never be able to penetrate. (1980, p. 269)[2]

Mises thought it impossible to distinguish the causal forces behind a change in prices merely from the knowledge of the price changes themselves. That these causal forces are inextricably intertwined is implied from the nature of a foundational concept in economics, namely, preference. Since preference in a market economy normally is manifested by an exchange of money for goods, any time a ranking changes, for example, a unit of good is now ranked above a sum of money instead of below it, one cannot distinguish

[2]It should be noted that contrary to Selgin and other proponents of modern free banking, Mises thought that a government-regulated money system was necessary to achieve the ideal "of enlightened statesmen and economists."

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from this fact alone whether the change is an increased demand for the good or a decreased demand for money. In fact, they are two ways of looking at the same thing. (Mises 1980, pp. 146, 153).

Although the division of determinants of changes in the exchange value of money into goods-side factors and money-side factors plays an essential role in developing theory about particular issues of money's value, it has no observable manifestation. Therefore, one cannot infer from the fact of a changed rank order of goods, let alone from the effects of such a change–for example, a rising exchange ratio of one good in terms of another–whether the value of one good has risen or the value of the other has fallen. Preferences are always relative, that is, comparisons between two options. This fact directly applies to questions concerning the measurement of money's value. Mises wrote:

> There are two parts to the problem of measuring the objective exchange value of money. First we have to obtain numerical demonstration of the fact of variations in the objective exchange value of money; then the question must be decided whether it is possible to make a quantitative examination of the causes of particular price movements, with special reference to the question whether it would be possible to produce evidence of such variations in the purchasing power of money as lie on the monetary side of the ratio. (1980, pp. 216-17)

Mises discusses the issues raised by attempts to measure money's value in considering the monetary policy proposed to achieve the inflationists' goal of perpetually stimulating economic activity and expanding exports while contracting imports. Although it is easy to imagine a situation in which the value of money falls by a constant rate, Mises denied that anyone could put such a monetary system into effect. He wrote:

> But however clearly we may be able to imagine such a monetary system, it certainly does not lie in our power actually to create one like it. We know the determinants of the value of money, or think we know them. But we are not in a position to bend them to our will. For we lack the most important prerequisite for this; we do not so much as know the quantitative significance of variations in the quantity of money. We cannot calculate the intensity with which definite quantitative variations in the ratio of the supply of money and the demand for it operate upon the subjective valuations of individuals and through these indirectly upon the market. This remains a matter of very great uncertainty. In employing any means to influence the value of money we run the risk of giving the wrong dose. This is all the more important since in fact it is not possible even to *measure* variations in the purchasing power of money. Thus even though we can roughly tell the direction in which we should work in order to obtain the desired variation, we still have nothing to tell us how far we should go, and we can never find out where we are already, what effects our intervention has had, or how these are proportioned to the effects we desire. (1980, pp. 256-57; emphasis in original)[3]

[3]Also, see, idem, pp. 218-19 and 270-71.

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Even if it were possible to accurately measure changes in money's purchasing power, policies to keep it falling at a constant rate (or for that matter stable) cannot be practiced because effects on money's purchasing power from changes in the money supply are determined by the subjective valuations of individuals as they change their preferences in the new situation. The impossibility of measuring money's purchasing power compounds the difficulty of forming policy, but it is not the root problem. Moreover, what gives rise to the political pressure that Selgin mentions is precisely the uncertainty about the need to intervene and the proper extent of intervention to counteract any undesirable changes in money's purchasing power, not "measurement problems" (Mises 1980, p. 269). As discussed below, Mises thought that the problems of measuring changes in the purchasing power of money that Selgin refers to, although theoretically impossible to solve, do not obstruct the conduct of monetary policy.[4]

Because these political pressures to conduct monetary policy would be absent in a gold standard, Mises concluded that a gold standard eliminates any arbitrary influence on money's purchasing power from the money side. Without this source of "instability," the gold standard is in theory more "stable," than a fiat money standard. About the political influences, Mises concluded:

> These possibilities, and the remembrance of very recent experiments in public finance and inflation, have subordinated the unrealizable ideal of a money with an invariable exchange value to the demand that the state should at least refrain from exerting any sort of influence on the value of money. A metallic money, the augmentation or diminution of the quantity of metal available for which is independent of deliberate human intervention, is becoming the modern monetary ideal. (1980, p. 269-70)

Far from joining the "enlightened statesmen and economists" in advocating a managed fiat money as the monetary ideal, Mises claimed that they were coming over to his view of the monetary ideal, that is, a metallic standard not subject to policy discretion. He based his claim on the following logic: eminent statesmen and economists desire a monetary system in which money-side fluctuations are absent; this requires a government managed system; but such a system will introduce an arbitrary destabilizing money-side influence on money's purchasing power; therefore, a metallic standard, although not without money-side influences on money's purchasing power, will be more stable; to most nearly attain their goal, the eminent statesmen and economists should prefer a metallic standard (Mises 1998, chaps. 26 and 27). Mises wrote:

> The significance of adherence to a metallic-money system lies in the freedom of the value of money from state influence that such a system guarantees. . . . It is true that [money-side] effects, in the case of gold (and even in the case of silver), are not immoderately great, and these are the only

[4]Selgin (1999, p. 267) himself quotes Mises on this very point.

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> two monetary metals that need be considered in modern times. But even if the effects were greater, such a money would still deserve preference over one subject to state intervention, since the latter sort of money would be subject to still greater fluctuations. (1980, p. 270)

Mises, then, was not asserting what Selgin (1999, p. 262) claims for him, that is, an "ideal of money with a constant inner objective exchange value (but with an *outer* exchange value that varied directly with changes in real output)." Instead, Mises was demonstrating why the advocates of such an ideal should prefer a gold standard. Mises's own reasons for favoring a gold standard, which are examined below, were much broader and deeper; in part ideological, in part theoretical, and in part historical.

The Proper Target for Monetary Policy

Selgin (1999, p. 262) also criticizes Mises for failing to recognize that the ideal he claims for Mises is "in essence, equivalent to the modern idea of a nominal income (GDP) target."[5] This equivalence, according to Selgin, obviates the need to construct a price index as a target for monetary policy and thus sidesteps Mises's criticisms of using a price index in conducting monetary policy—which, to reiterate, Selgin considers Mises's primary criticism of policy that targets money's purchasing power. He speculates (Selgin 1999, p. 267) that one reason "Mises himself . . . never recognized the equivalence of a stable inner objective exchange value of money and stable nominal income" was "his refusal to employ the equation of exchange as a tool of reasoning." It seems unnecessary to speculate on his reasons, however. As outlined above, Mises thought the fundamental problem in conducting monetary policy that targeted money's exchange value was the impossibility of bifurcating goods-side and money-side influences on the purchasing power of money. No one can detect from any particular change in price of something what the underlying causal force is, whether it is goods side or money side. Therefore, one cannot find an accurate quantitative division of the total change in price into goods-side and money-side influences. Absent this division, one cannot determine the correct dose of monetary expansion or contraction, or even whether the money supply should be increased or decreased to hit the target. Mises did argue, as Selgin claims, that there is no unique, correct way to construct a price index and thus, using some price index as a measure of changes in money's purchasing power is arbitrary and the selection of which one to use is then subject to political pressure. But this point is not his fundamental criticism of a monetary policy that aims at eliminating money-side influences on prices. Even if some price index did, with unique correctness, measure

[5]Selgin deduces this from the quantity equation, $MV=Py$, by rearranging terms to show that $1/P=y/MV$ and thus nominal income (which equals MV) is equivalent to the money-side influences and is separable from the goods-side influences (namely, y) on money's purchasing power (namely, $1/P$).

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changes in the purchasing power of money (so that all parties would agree to adopt it), one could not use the knowledge it provided about changes in money's purchasing power to bifurcate the total change into goods-side and money-side influences (Mises 1980, p. 218). The problem Selgin cites is just another strike against a managed fiat-paper money system for Mises, but not the decisive blow.

Moreover, it is doubtful that Mises would agree with Selgin's claim that such bifurcation can be done based on the equivalence between a stable nominal income and a stable inner objective exchange value of money. His rejection of Selgin's claim can be inferred from his discussion of Wieser's proposal to use real and nominal income as a method of calculating a price index (Mises 1980, pp. 219-20). Although not identical to Selgin's constant nominal income target, Wieser's scheme elicited the following criticism from Mises that can be applied to Selgin's suggestion. Mises wrote:

> The technical difficulties in the way of employing this method, which is the most nearly perfect and the most deeply thought out of all methods of calculating index numbers, are apparently insurmountable. But even if it were possible to master them, this method could never fulfill the purpose that it is intended to serve. It could attain its end only under the same supposition that would justify all other methods; namely, the supposition that the exchange ratios between the individual economic goods excluding money are constant, and that only the exchange ratio between money and each of the other economic goods is liable to fluctuation. This would naturally involve an inertia of all social institutions, of population, of the distribution of wealth and income, and of the subjective valuations of individuals. Where every thing is in a state of flux the supposition breaks down completely. (1980, p. 220)

Only if one assumes that goods-side influences are unchanged can he identify, from any change in price, the money-side influence. But goods-side influences are in continual flux and indissolubly intermixed with money-side influences. And this is true whether nominal income is rising, staying the same, or declining. A constant nominal income does not ensure constancy of the underlying demands for and supplies of goods and money and thus is no guide to bifurcating goods-side and money-side influences and, by implication, no guide to monetary policy that targets money's value. Moreover, if nominal income could be kept constant only by a government policy of changing the money stock to offset any changes in money demand (thereby neutralizing any money-side influence) as Mises thought would be necessary to conduct such monetary policy, far from neutralizing the effect of the change in money demand, this would inject a second money-side influence into the economy on top of the (presumed) change in money demand.[6] Even if monetary policy could put the additional money directly and immediately into the

[6]This conclusion follows from Mises's concept of the nonneutrality of money. See Mises (1980, pp. 61-62 and 160-68; 1998, p. 414).

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hands of those particular people whose money demands had changed and in an amount proportional to the changes in money demand for each person, a change in money supply would still fail to neutralize a change in money demand since the effects on prices of the two changes are determined by subjective valuations, which can be different in different circumstances (Mises 1980, pp. 218-19). What makes the managed monetary system less stable than the gold standard, according to Mises, is that it lacks this policy-induced money-side influence on money's purchasing power.

Theory and History

Selgin alleges another problem with Mises's arguments about a gold standard vis-à-vis a fiat-money standard: inconsistency between his two conclusions. On the one hand, Mises holds that "gold is to be preferred to managed (fiat) money because of the lack of a reliable measure of money's purchasing power," but, on the other hand, he holds that "gold is to be preferred to managed money because the gold standard is more stable in practice" (Selgin 1999, p. 265). Selgin's assessment of Mises's case for gold is wrong on both counts. As discussed above, his claim that Mises favored gold because of the impossibility of constructing a scientific, that is, non-arbitrary, measure of money's purchasing power ignores Mises's more fundamental argument about the impossibility of bifurcating money-side and good-side influences on money's purchasing power. Selgin's claim that Mises preferred the gold standard because of its superior stability is also wide of the mark. One of the distinguishing features of Mises's monetary theory is his position that monetary stability is a chimera. Mises was fully aware that no monetary system, the gold standard included, could be judged on this ground. "The purchasing power of gold is not stable," he wrote, "but the very notions of stability and unchangeability of purchasing power are absurd." Even so, what Mises claimed for the gold standard is that "nobody is in a position to tell us how something more satisfactory could be put in [its] place." Mises did not think that the gold standard was the best monetary system because it was the most stable. His defense of the gold standard on this point was that it fettered the inflationary impulse of government, not that it attained the utopia of stability. "The adversaries of the gold standard do not want to make money's purchasing power stable," he wrote, "they want rather to give to the government the power to manipulate purchasing power without being hindered by an 'external' factor, namely, the money relation of the gold standard" (Mises 1998, pp. 470-71).

But even if Selgin's assessment of Mises's arguments was correct, his own demonstration that Mises was inconsistent is faulty. Quoting Mises, Selgin writes:

> Ultimately Mises has no choice but to abandon his extreme position concerning the uselessness of index numbers. This allows him to suggest that gold has indeed performed better historically than irredeemable paper. It also serves to effectively undermine his claim that measurement problems

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> alone must render a managed money standard impracticable: "The inadmissibility of the methods proposed for measuring variations in the value of money does not obtrude itself too much if we only want to use them for solving practical problems of economic policy." (1999, p. 267)

Selgin has here mischaracterized Mises's claims. Although Mises did demonstrate the impossibility of any price index to measure money's purchasing power with scientific accuracy (or to divide goods-side from money-side influences on money's purchasing power, as shown above), he did not claim that "measurement problems alone must render a managed money standard impracticable." Mises did not even hold that a price index was useless for every purpose. Continuing from the quotation Selgin cites above, Mises wrote:

> Even if index numbers cannot fulfill the demands that theory has to make, they can still, in spite of their fundamental shortcomings and the inexactness of the methods by which they are actually determined, perform useful workaday services for the politician.
>
> If we have no other aim in view than the comparison of points of time that lie close to one another, then the errors that are involved in every method of calculating numbers may be so far ignored as to allow us to draw certain rough conclusions from them. . . . [W]e can follow statistically the progress of variations in purchasing power from month to month. (1980, p. 222)

Although Selgin denies the validity of Mises's approach, by which he holds simultaneously that a price index is useless in a theoretical task but useful in a practical task,[7] Mises (1985) grounded this position in his distinction between praxeology, the logic of action, which is the method of economic theory, and *verstehen*, the specific understanding of action, which is the method of history. Some claims impermissible in one realm are permissible–and, in some cases, indispensable–in the other. For example, praxeology says nothing about the particular concrete ends that action aims to attain or the particular means a person employs in action, instead treating ends and means in a purely conceptual manner, but *verstehen* must make statements about the particular ends that individuals aim to attain by employing particular means. Mises held that theory is the prism through which historical events are understood, but without investigation into the concrete circumstances of events, theory alone could not render historical understanding. Although one must take care in interpreting data, these data can serve the purpose of historical investigations even though they are suspect in theoretical purposes. Many types of data could fall into this category: national income, average wages, and per-capita capital stock, just to name a few. All of these may find a use in historical explanations while being deficient for theoretical purposes.

Instead of recognizing Mises's distinction between theory and history, Selgin asserts that Mises is making a strictly theoretical argument. He chides

[7]For Selgin's position on this distinction, see Selgin (1999, p. 265).

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Mises for noting, in defense of his pro-gold position, that the most extreme inflations have been with fiat paper money, such as in Germany after the First World War. Selgin (1999, p. 266) takes Mises to be making an "argument" from this observation that "fiat money is generally inferior to gold," which, if he was doing, Selgin would be correct in deeming it "far from adequate." But Mises was not trying to prove a theoretical point with this historical observation; he was simply illustrating that in fact fiat-paper standards have had more extreme episodes of price inflation than gold standards. The theoretical demonstration of why one should expect to find this result in history is his argument about the political impetus to inflate with a managed fiat-money system examined above.

Moreover, contra Selgin, Mises did not think it possible to construct an *a priori* argument for gold, much less the "public-choice style argument" Selgin assigns to him.[8] Mises (1998, p. 402) accepted Carl Menger's demonstration that money can only originate on the market and considered it "an irrefutable praxeological theory." Just as the pre-monetary barter market gave birth to a medium of exchange, as a widely salable commodity, money's development can be left to the market. The use of a medium of exchange becomes more widespread because traders see it in their interest to use a medium that is more widely traded. The more traders who use it the more attractive it becomes as a medium. Also, people will supplant commodities less able to perform the medium of exchange function with those better able to do so, and thus the precious-metal standard emerges. "Men have chosen the precious metals gold and silver for the money service," Mises (1998, p. 468) wrote, "on account of their mineralogical, physical, and chemical features." Although the use of money can be known praxeologically, the particular standard can only be known from the concrete facts of history. "The use of money in a market economy," (Mises 1980, p. 468) "is a praxeologically necessary fact. That gold–and not something else–is used as money is merely a historical fact and as such cannot be conceived by catallactics." Mises neither thought that any *a priori* case could be made for any particular precious metal, such as gold (but only an historical one), nor did he make any "public-choice-style arguments" in favor of gold. Contra Selgin, his argument for the gold standard had both ideological and historical elements.

The Ideological Battle Over the Monetary Standard

The use of the precious metals was historically the choice of the market. Without interference from governments, traders adopted the parallel standard

[8]Selgin claims that Mises "implicitly employs something like a Rawlsian 'veil of ignorance' argument" in defending the gold standard. He then goes on to criticize Mises on the grounds that this argument "confuses the ignorance induced by donning a Rawlsian veil with ignorance *tout court*" (1999, p. 269). The argument Mises actually made in defense of the gold standard is outlined below.

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using gold and silver as money (Mises 1998, p. 419). During the nineteenth century, however, interventions on the part of various governments supplanted the parallel standard of gold and silver with the monometallic gold standard. Some governments intended to do so, and others did so as a secondary effect of pursuing other ends. "Once the economically most advanced nations had adopted the gold standard," Mises (1998, p. 469) wrote, "all other nations followed suit." Once in place, however, the gold standard provided an international money that permitted the development of a worldwide division of labor, which was the "greatest and most beneficial of all historical changes," Mises wrote. It increased welfare, spread liberty, and "accompanied the triumphal unprecedented progress of Western liberalism ready to unite all nations into a community of free nations peacefully cooperating with one another" (Mises 1998, p. 470).

The fly in the ointment of the classical gold standard was precisely that since it was created and maintained by governments, it could be abandoned and destroyed by them. As the ideological tide turned against laissez-faire in favor of statism, governments intent upon expanding the scope of their interference in and control of the market economy found it necessary to eliminate the gold standard. Nationalists wanted autarky, pressure groups sought higher wages, and, most important of all, demands were made for credit expansion by which everyone could be made prosperous and happy. "Only the gold standard," Mises (1998, p. 470) wrote, "that devilish contrivance of the wicked and stupid 'orthodox' economists, prevents mankind from attaining everlasting prosperity."

For Mises the political problem of the monetary standard did not revolve around a narrow rent-seeking cabal of special-interest groups haggling over which price index to target with monetary policy. It arose from ethnic and ideological forces, both political and economic. Selgin's (1999, pp. 259-60) focus on Mises's claim "that disagreements concerning the direction and extent of changes in money's purchasing power must render a managed fiat money a plaything of politics," is the proverbial tip of the iceberg. The impetus behind inflation and the destruction of the gold standard was much broader and squarely ideological. "[G]eneral acceptance [of the gold standard] requires the acknowledgement of the truth that one cannot make all people richer by printing money," Mises (1998, pp. 471-72) wrote, "the abhorrence of the gold standard is inspired by the superstition that omnipotent governments can create wealth out of little scraps of paper." Those who propagated this superstition "loathed the gold standard" because they were "intent upon sabotaging the evolution toward welfare, peace, freedom, and democracy," Mises wrote, "in their eyes the gold standard was the labarum, the symbol, of all those doctrines and policies they wanted to destroy. In the struggle against the gold standard much more was at stake than commodity prices and foreign exchange rates" (1998, p. 470). Mises wrote:

> The struggle against gold which is one of the main concerns of all contemporary governments must not be looked upon as an isolated phenomenon. It is but one item in the gigantic process of destruction which is the

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> mark of our time. People fight the gold standard because they want to substitute national autarky for free trade, war for peace, totalitarian government omnipotence for liberty. (1998, p. 473)

What the advocates of inflation find objectionable about the gold standard is precisely that it constrains the government's ability to inflate, and by limiting this power, cripples its ability to attain the ends at which the advocates of inflation aim. "What the expansionists call the defects of the gold standard are indeed its very eminence and usefulness," Mises wrote, "it checks large-scale inflationary ventures on the part of governments." The "inflationists" destroyed the gold standard "because they were committed to the fallacies that credit expansion is an appropriate means of lowering the rate of interest and of 'improving' the balance of trade" (Mises 1998, pp. 471-72). By defending the gold standard, Mises was defending the world economy from its ideological enemies.

Costs and Benefits of the Gold Standard

The manner in which a supplier of gold coin, whether private enterprise or a government agency, is restrained from inflating the money stock under a gold standard is the market's imposition of gold's production costs on the profitability of its production. "The significance of the fact that the gold standard makes the increase in the supply of gold depend upon the profitability of producing gold is, of course," Mises wrote, "that it limits the government's power to resort to inflation." As a result, money's purchasing power is made independent of politics, which "is not a defect of the gold standard; it is its main excellence" (Mises 1998, p. 471). Moreover, Mises pointed out that the lower the costs of producing gold coin sink, the greater would be the incentive to produce and supply more. If, say through technological innovation, production costs became negligible, as with a fiat paper money, the incentive to inflate would be nearly unlimited. Then gold would no longer be useful as money and traders would need to replace gold with something else (1998, p. 473).

Far from recognizing Mises's argument that the cost of producing gold was a bulwark against inflation, Selgin's only mention of his views on the costs of gold production is as a "social cost of deflation." "Under a gold standard," Selgin (1999, p. 261) writes, "deflation becomes equivalent to a rising relative price of gold, which in turn means a greater diversion of resources to gold mining." But here again Mises is discussing this question in a historical context, namely, the "extension of the money economy," where he presumes that money's purchasing power would have risen in the absence of the "extension of money-economizing means of payment," such as the clearing system and fiduciary media (Mises 1980, p. 333). Mises's assessment of the force behind potential deflation as he looked back upon history in 1924 was the historical spread of the worldwide division of labor. He (Mises 1980, p. 359) is not discussing the growth of an existing monetary economy, but the extension

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of the use of money and the money economy.[9] In that period of history when the money economy was spreading across the world, price deflation would have been observed had it not been for the extension of money-economizing means of payment, Mises presumes, and along with it the diversion of factors of production into producing the monetary metal and, thus, the social costs of deflation. But that period of history is over. The world economy became a reality, and with it the possibility of a disruptive type of deflation evaporated.

Moreover, Joseph Salerno has demonstrated that in completing his monetary theory during the years from 1912 to 1949, Mises abandoned the view he held earlier that "an increase in the purchasing power of money is somehow disadvantageous for the market economy." By the time Mises penned *Human Action*, he realized that when money demand increased as the result of economic growth–even with a constant money stock and, therefore, a rising purchasing power of money–it would not impair the process of pricing or economic calculation. Thus, economic growth would not be retarded (Salerno 1993, pp. 143-45).

White makes a much stronger claim than Selgin regarding Mises's position on the resource costs of a gold standard. In summarizing Mises's views, White (1992, p. 522) writes, "he viewed fractional-reserve banking as a natural and desirable development in a free society, most importantly because it reduced the resource costs associated with the payments system." White (1992, p. 520) notes Adam Smith's view, which Mises refers to in *The Theory of Money and Credit*, that replacing a metallic standard with paper substitutes an expensive medium of exchange with a less expensive one (Mises 1980, p. 332). But although Mises considered the classical view theoretically correct in 1924, his examination of the historical development of government intervention in money and banking led him to change his assessment of its importance in history by 1949.[10] He wrote:

> In examining the evolution which gave governments the power to manipulate their national currency systems, we must begin by mentioning one of the most serious shortcomings of the classical economists. Both Adam Smith and David Ricardo looked upon the costs involved in the preservation of a metallic currency as a waste. As they saw it, the substitution of paper money for metallic money would make it possible to employ capital and labor, required for the production of the quantity of gold and silver needed for monetary purposes, for the production of goods which could directly satisfy human wants. Starting from this assumption, Ricardo elaborated his famous *Proposals for an Economical and Secure*

[9]Contrary to White's assertion, Mises is not agreeing in this passage with the free bankers' position that in a growing economy an increase in fiduciary media is necessary to accommodate an increase in money demand. See White (1992, pp. 520-21, 523). Also, on this point see Selgin and White (1996, p. 98).

[10]Also on Mises's view of the resource costs of a gold standard, see Salerno (1993, p. 144). Mises had revised his more favorable assessment on Adam Smith's position, which he held in 1924, by the time he wrote his article "Monetary Stabilization and Cyclical Policy," in 1928. See, Mises (1978, pp. 72-74).

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> *Currency*, first published in 1816. Ricardo's plan fell into oblivion. It was not until many decades after his death that several countries adopted its basic principles under the label *gold exchange standard* in order to reduce the alleged waste involved in the operation of the gold standard nowadays decried as "classical" or "orthodox." (Mises 1998, p. 780)[11]

Also, it should be kept in mind that the reason Mises gave for the resource cost advantage of a paper money during deflation was derived from Hume's argument showing that any stock of money can perform the entire medium-of-exchange function; a smaller stock would do so with lower prices, and a larger stock with higher prices (Mises 1980, pp. 165 and 333). Despite the greater regard he once held for Adam Smith's view, Mises's position was always much different from that of the modern free bankers who do believe there is an optimum amount of money and who do believe there is a social benefit to increasing the money stock in response to an increase in money demand.[12]

Also by 1949, Mises came to recognize that the resource costs associated with a gold standard pale in significance compared to the destruction wrought by inflation. "If one looks at the catastrophic consequences of the great paper money inflations," Mises (1998, p. 419) wrote, "one must admit that the expensiveness of gold production is the minor evil."

But whatever the reality and extent of diversion of resources into gold mining during deflation, it is clear that by 1949 Mises did not consider deflation a likely problem. Inflation, once government has monopolized the production of money, is the real danger. As long as there is a significant inflationary impulse (always strengthened by government intervention into money and credit), the cost of producing gold is its main advantage as a money since this is what restrains the inflationary impulse.

Gold and the State

Although governments did establish and rule over the classical gold standard, Mises did not think the market economy required such oversight. He recognized that the gold standard had come to transcend governments. International trade had created a worldwide division of labor based on gold, which "works without any action on the part of governments." Not only is there "no need for any government to interfere in order to make the gold standard work," Mises wrote, "no government is . . . powerful enough to abolish the gold standard." Because "gold is the money of international trade and of the super-national economic community of mankind," its preservation and

[11]That he came to realize the implications of the Smith-Ricardo view only after 1924 helps to explain his remark that "in dealing with the problems of the gold exchange standard all economists–including the author of this book–failed to realize the fact that it places in the hands of governments the power to manipulate their nations' currency easily" (Mises 1998, p. 780).

[12]On the free bankers' position, see White (1992, p. 523).

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purification were necessary components of Mises's plan for the restoration of a liberal social order (1998, pp. 472-73).

Mises's defense of the gold standard, then, was part and parcel of his indefatigable drive for a liberal society. Such a society is put into place by the strictest limits on the power of the state. "Government means always coercion and compulsion and is by necessity the opposite of liberty," Mises (1998, p. 283) wrote, "[it] is a guarantor of liberty and is compatible with liberty only if its range is adequately restricted to the preservation of economic freedom." In short, the liberal society is achieved when state coercion is limited to defense of person and property (Mises 1998, p. 720).

Mises argued that money, like all other goods, is part of the private property order of the market, and thus, outside the realm of state power, which was to be restricted to defense of person and property. He wrote:

> Money is the commonly used medium of exchange. It is a market phenomenon. Its sphere is that of business transacted by individuals or groups of individuals within a society based on private ownership of the means of production and the division of labor. (Mises 1980, p. 478)

If the market would have been unhampered by government intervention into monetary affairs in the nineteenth century, the parallel standard, already developed in history, would have been maintained and no reform would be necessary. But governments did interfere and created the gold standard, which became the money of the world economy. Because the gold standard was the world's monetary system in 1949, Mises argued, reform projects must first seek to preserve it and second to purify it of its interventionist elements.[13]

Theory and History of Money Substitutes

If in a liberal social system money proper is to be left to the choice of the market and private enterprise, what about the monetary function of banks? As with other issues of monetary systems, Mises argued that there are praxeological and historical dimensions regarding the monetary function of banking. The praxeological function banks have performed is in producing money substitutes, which "render to the individual all the services money can render" Mises (1998, p. 429) wrote and thus, "they can fully replace money in an individual's or a firm's cash holdings." To do this, a money substitute must be a claim to a definite amount of money that is redeemable on demand against the issuer, for whom no doubt exists about his ability and willingness to pay and

> that all parties with whom he could possibly transact business are perfectly familiar with these essential qualities of the claims concerned. . . . The main thing is that *every owner* of a money-substitute, is perfectly certain that it can, at every instant and free of expense, be exchanged against money. (Mises 1998, pp. 429-30; emphasis added)

[13]This point is pursued below.

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The legal claim that the money-substitute makes is part and parcel of the general legality of contract and must be upheld, and enforced if necessary, by the legal system. Contrary to Selgin (2000, p. 95), who asserts that the indefinite public knowledge that banks, in general, do not hold 100-percent reserves is sufficient to justify fiduciary media, according to Mises, to be a money-substitute all traders in the market must be fully informed of the legal character of the claim and the financial character of the institution that issues it. Then and only then will the banks have a clientele for their products and not merely customers; then and only then will the claims be money-substitutes, that is, be, like money itself, generally accepted as a medium of exchange. "People deal with money-substitutes as if they were money," Mises wrote, "because they are fully confident that it will be possible to exchange them at any time without delay and without cost against money." Only those who have this confidence, that is, deal with money-substitutes as if they were money, are clients of the issuer. The crucial factor determining confidence in a bank, or lack thereof, is the actual practice of redemption. "What counts," Mises wrote, "is whether the money-substitutes can really be exchanged against money without delay and cost" (Mises 1998, pp. 431-32).

Historically, banks have issued two types of money-substitutes: money-certificates, for which the bank "keeps against the whole amount of money-substitutes a reserve of money proper," and fiduciary media, which is "the amount of substitutes which exceeds the reserve" (Mises 1998, p. 430). Since the issue of either type of a money-substitute depends on clients who are "perfectly certain that it can, at every instant and free of expense," be redeemed for money, money-certificates are necessary for the existence of fiduciary media. Without a reserve held against some money substitutes, no fiduciary media could be issued at all. Fiduciary media, for Mises, are entirely dependent upon the existence of money certificates. The requirement for the legality and viability of money-substitute is the contractual obligation for the issuing bank to redeem the money-substitute for money at par on demand, and this requirement can only be met if the bank holds sufficient reserves of money. Mises wrote:

> It is very easy for a bank to increase the number of people who are ready to accept loans granted by credit expansion and paid out in an amount of money-substitutes. But it is very difficult for any bank to enlarge its clientele, that is, the number of people who are ready to consider these claims as money-substitutes and to keep them as such in their cash-holdings. To enlarge this clientele is a troublesome and slow process, as is the acquisition of any kind of good will. On the other hand, a bank can lose its clientele very quickly. If it wants to preserve it, it must never permit any doubt about its ability and readiness to discharge all its liabilities in due compliance with the terms of the contract. A reserve must be kept large enough to redeem all banknotes which a holder may submit for redemption. Therefore no bank can content itself with issuing fiduciary media only; it must keep a reserve against the total amount of money-substitutes issued and thus combine issuing fiduciary media and money-certificates. (1998, p. 436)

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For Mises, free banking meant that banks have a legal obligation to redeem all money-substitutes, whether money-certificates or fiduciary media, into money at par on demand and must in practice never reveal any doubt as to their readiness and ability to do so. Banks do not have an inviolable right to issue fiduciary media itself, but only money-substitutes. Selgin and White, in contrast, wish to "defend the freedoms to issue and use fiduciary media of exchange," as a basic right of contract. "Outlawing voluntary contractual arrangements that permit fractional reserve-holding," they write, "is thus an intervention into the market, a restriction on the freedom of contract which is an essential aspect of private property rights" (Selgin and White 1996, pp. 83, 87).

The danger in issuing fiduciary media is that it makes the bank's legal obligation to redeem subject to the confidence that clients have in the bank. This fact, Mises thought, was an essential feature of issuing fiduciary media and granting circulating credit, the danger of which is ever present. The clients' confidence in the bank cannot be apportioned according to whether one holds money-certificates or fiduciary media. "As a rule," Mises (1998, p. 430) wrote, "it is not possible to ascertain whether a concrete specimen of money-substitute is a money-certificate or a fiduciary medium." Yet, confidence in the bank is indissoluble, Mises thought: "it is either present with all its clients or it vanishes entirely." For this reason, the purpose of holding reserves is not to redeem the banknotes of those who have lost confidence in the bank, but to hold a reserve large enough that the practice of redemption is never suspended and, thus, confidence is never lost. "A reserve must be kept large enough," Mises wrote, "to redeem all banknotes which a holder may submit for redemption." This all-or-nothing nature of the clientele's confidence in the bank "is an essential feature or weakness of the business of issuing fiduciary media and granting circulation credit. . . . No system of reserve policy and no reserve requirements as enforced by the laws, can remedy it" (Mises 1998, p. 436).

Disregarding these passages, Selgin and White cite Mises in favor of their position that because the issue of fiduciary media is a basic right of contract, redemption is merely a technical question whose dangers can be efficiently managed. Bankers must, by entrepreneurial judgment, determine a redemption policy that makes fiduciary media sustainable as a medium of exchange, which they characterize as a risk-management problem. Bank runs, according to Selgin and White, could be dealt with pragmatically with, for example, option clauses for suspension of specie redemption. Mises, as implied above, would not permit such suspension under any circumstances. The law must enforce the redemption of all money-substitutes under any conditions. Moreover, in the citation of Mises they attempt to use to bolster their position, he is explaining how a claim on money as property can be a medium of exchange and have par value with money, without being backed by money while a claim on consumer goods as property must be fully backed by the goods to have par value with the goods. As noted above, Mises argued that the viability of fiduciary media depended on the confidence holders have in their redemption. In the passage cited by Selgin and White, he merely adds that such confidence depends on the prudence of bankers in issuing fiduciary

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media. Mises is not claiming what Selgin and White do, that because the issue of fiduciary media is a basic right of contract, their viability is a manifestation of satisfying the demand people have for them, as it would be for consumer goods. As shown above, according to Mises, people only demand money-substitutes, not fiduciary media, and their demand exists only when they have confidence in full redemption based on the issuers practice of full redemption. People could not demand fiduciary media because they cannot distinguish between a money-substitute that is a money-certificate and one that is a fiduciary medium. If they could make such a distinction, then fiduciary media would not be viable (Selgin and White 1996, pp. 90-92).[14]

Fiduciary Media and Credit Expansion

Although clients of a bank cannot distinguish between its money-certificates and fiduciary media, the effects of issuing the two types of money-substitutes are different. The issue of money-certificates neither changes the money stock nor expands bank credit. "A bank which does not issue fiduciary media," Mises wrote, "can only grant *commodity credit*, that is, it can only lend its own funds and the amount of money which its customers have entrusted to it." But issuing fiduciary media permits credit expansion. A bank, Mises wrote, "can now not only grant commodity credit, but also *circulation credit*, that is, credit granted out of the issue of fiduciary media." The result of an issue of fiduciary media is a reduction in money's purchasing power and the rate of interest (Mises 1998, pp. 430-31; emphasis in original).

Fiduciary media, then, is the source of credit expansion and credit expansion is an integral part of the trade cycle. "The term *credit expansion* has often been misinterpreted," Mises (p. 431, emphasis in original) wrote, "it is important to realize that commodity credit cannot be expanded. The only vehicle of credit expansion is circulation credit."[15] Mises wrote:

> The notion of "normal" credit expansion is absurd. Issuance of additional fiduciary media, no matter what its quantity may be, always sets in motion those changes in the price structure the description of which is the task of the theory of the trade cycle. Of course, if the additional amount issued is not large, neither are the inevitable effects of the expansion. (1998 p. 439, n. 17)

In contrast to Mises, Selgin argues that the additional issue of fiduciary media, and the consequent credit expansion, does not engender the trade

[14]The passage they cite is Mises (1980, pp. 299-300).

[15]Mises held that the major drawback of issuing fiduciary media was the resulting business cycle and, once his views were fully developed, he held that this drawback alone was sufficient to outweigh any advantages fiduciary media may have. See, Salerno (1993, pp. 139-41). Basing their position on Mises's underdeveloped view, Selgin and White (1996, p. 94) claim that Mises found the benefit of the saving of resource costs greater than the harm of cyclical instability.

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cycle if the additional fiduciary media is accommodating an increase in money demand. Selgin writes:

> Anyone who finds even a grain of truth in the Austrian theory of the business cycle appreciates that excessive growth of the money stock can trigger or worsen industrial fluctuations. It does not follow, however, that fractional reserves are to blame for such fluctuations, or that an economy relying on one hundred percent reserve banks only would necessarily be cycle-free.
>
> In truth, whether an addition to the money stock will aggravate the business cycle depends entirely on whether or not the addition is warranted by a preexisting increase in the public's demand for money balances. . . . As far a business-cycle consequences are concerned, it makes no difference whether the new money is or is not backed by gold. (2000, p. 97)[16]

In Mises's view, any additional fiduciary media sets in motion the trade cycle. The only circumstances under which issuing fiduciary credit would not lead to credit expansion is if the new issue is replacing a retiring issue of fiduciary credit and thus no additional fiduciary media comes into existence. "Credit expansion is present only if credit is granted by the issue of an additional amount of fiduciary media," Mises (1998, p. 431) wrote, "not if banks lend anew fiduciary media paid back to them by the old debtors."

Theory and History of Fiduciary Media

Mises's earlier writings about fiduciary media must also be read in the context of the historical period that Mises is trying to explain. Thus, as with the claim by Selgin and White that Mises lends support to banks issuing fiduciary media today because he argued that such media once played an important role in preventing deflation, the claim by White (1992, p. 522) that Mises's assertion that the historical development of banking was aided by the issuing of fiduciary media lends no support to continuation of this practice. Mises wrote:

> In the early days of the modern banking system [fiduciary media] played a further part still by strengthening the credit-negotiating activities of the banks (which in those times could hardly have proved profitable if carried on for their own sake alone) and so brought the system safely past those obstacles which obstructed its beginnings. (1980, p. 359)

But now that the banking system is fully developed, this benefit no longer accrues to the continuing existence or further issuing of fiduciary media. Even Mises's claim in 1924 must be understood as a historical one. He wrote:

> Prohibition of the issue of all notes except those with a full backing and of the lending of the deposits which serve as the basis of the check-and-clearing

[16]See also Selgin and White (1996, pp. 102-03).

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> business would mean almost completely suppressing the note issue and almost strangling the check-and-clearing system. (Mises 1980, pp. 359-60)

But following this quotation that White cites, Mises wrote:

> If notes are still to be issued and accounts opened in spite of such a prohibition, then somebody must be found who is prepared to bear unrecompensed the costs involved. Only very rarely will this be the issuer, although occasionally such a thing happens. (1980, p. 360)

So in any historical context where it is possible for the issuer to be compensated for fully backed money-substitutes, which Mises thought even before 1924 occasionally happened, this benefit of fiduciary credit disappears. He wrote:

> Issuing money-certificates is an expensive venture. . . . a ruinous business if not connected with issuing fiduciary media. In the early history of banking there were banks whose only operation consisted in issuing money-certificates. But these banks were indemnified by their clients for the costs incurred. (1998, p. 432)

This was possible because of people's preference for different forms of cash holdings. If people consider banknotes more convenient than coins, they "would be prepared to pay a premium," for them. Mises cites both "banknotes issued by banks of unquestionable solvency" and travelers' checks as examples of the public's greater demand for certain forms of media of exchange resulting in a premium high enough to cover the costs of their production (Mises 1998, p. 443).

Mises not only thought it possible for banks in a developed market system to be able to cover the costs of issuing only money-certificates, he claimed that the historical importance of fiduciary media was a result of government intervention. Mises did not think that fractional reserve banking was a "natural and desirable development in a free society," as White (1992, p. 522) claims for him. To the contrary, Mises thought that if banking had been unhampered by government intervention, fiduciary media would have never been an important factor in banks issuing money-substitutes. He wrote:

> The issue [of the public acceptance of banknotes] can still better be clarified by reviewing banking conditions in continental Europe. Here the commercial banks were free from any limitation concerning the amount of deposits subject to check. They would have been in a position to grant circulation credit and thus expand credit by adopting the methods applied by the banks of the Anglo-Saxon countries. However, the public was not ready to treat such bank deposits as money-substitutes. . . . Only a small group of big business treated deposits with the country's Central Bank of Issue (not those with the commercial banks) as money-substitutes. Although the Central Banks in most of these countries were not submitted to any legal restrictions with regard to their deposit business, they were prevented from using it as a vehicle of large-scale credit expansion because the clientele for deposit currency was too small. Banknotes were practically the sole

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> instrument of circulation credit and credit expansion. Similar conditions prevailed and for the most part still prevail by and large in all countries of the world which are outside the pale of Anglo-Saxon banking methods. (Mises 1998, p. 442)

Not only did Mises claim that lack of public demand for deposits limited their use, whether money-certificates or fiduciary media, to a small cadre of traders, he also held that the widespread use of banknotes was unnecessary to the development of the market economy. "Banknotes are not indispensable," he wrote, "all the economic achievements of capitalism would have been accomplished if they had never existed" (Mises 1998, p. 444).

Moreover, the rise of banknotes was not the result of public demand, but government intervention.[17] "However, freedom in the issuance of banknotes," Mises (1998, p. 443) wrote, "would have narrowed down the use of banknotes considerably if it had not entirely suppressed it." It was not the market, but government, that gave rise to the widespread use of banknotes. Mises wrote:

> But this present state of banking is not the outcome of the operation of the unhampered market economy. It is a product of the various governments' attempts to bring about the conditions required for large-scale credit expansion. If the governments had never interfered, the use of banknotes and of deposit currency would be limited to those strata of the population who know very well how to distinguish between solvent and insolvent banks. No large-scale credit expansion would have been possible. (1998, p. 444)

Governments, according to Mises, were not aiming at developing the banking system or the market economy, but had only the goal of easing the burden of their own financing in mind when helping banknotes develop. "Governments did not foster the use of banknotes in order to avoid inconvenience to ladies shopping," Mises (1998, pp. 443-44) wrote, "their idea was to lower the rate of interest and to open a source of cheap credit to their treasuries."

In Mises's view, banknotes played a significant, and pernicious, role in history because governments interfered to bring about their widespread use and deposit currencies, even as late as 1949, played no significant widespread role in history because people did not desire them. Although White (1992, p. 526) agrees that Mises is claiming that money-substitutes would not have played a significant role in history absent government intervention, he fails to realize that without their widespread issue, free banks could not play the role of expanding the money stock to accommodate increases in money demand.

Today it can hardly be disputed that charges for checking accounts are commonplace and would not stifle the issue of money-certificates as the only form of money-substitutes. But even if banks could not profit from issuing money-substitutes, Mises would consider it a good thing, since it would restrict banknotes to a small fraction of commerce and thus discourage the development of fiduciary banknotes and "large-scale" credit expansion. In any case, whatever one's view of these historical issues, Mises clearly thought that

[17] Also, on this point, see Salerno (1993, p. 142).

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the form of money substitute was not an issue that could be settled by catallactics. "At any rate, catallactics is not interested in the purely technical problems of banks not issuing fiduciary media," Mises (1998, p. 432) wrote, "the only interest that catallactics takes in money-certificates is the connection between issuing them and the issuing of fiduciary media."

This distinction between money-certificates and fiduciary media is important because issuing the latter results in credit expansion, the very force Mises was interested in curbing. "Hence the question of whether there are or are not limits to the increase in the quantity of fiduciary media," Mises (1998, p. 432) wrote, "has fundamental importance." This is why Mises (1998, pp. 432-36) took time to dwell on the consequences of different configurations of free banking. Three features of his analysis stand out vis-à-vis the modern Free Banking School. First, all of these configurations presume gold as money and differ only in the conditions under which banks issue money-substitutes. Modern advocates of free banking do not agree that free banking is a market monetary system only if it has gold as money (Rothbard 1992, p. 99).[18] Second, unlike the modern free bankers, Mises did not think that outlawing the issue of fiduciary media violated a basic right of contract. Instead, fractional reserve banking was one possible configuration of legally permissible bank activity, and not the one that attained his goal of restricting credit expansion as far as possible. Third, Mises demonstrated that free banking, with the legal right to issue fiduciary media, is a superior alternative to an interventionist system of government privilege, which permitted the suspension of specie redemption. By superior, he meant that this system would restrict credit expansion more than a system with one monopoly bank or a bank cartel (Mises 1998, pp. 433-34).

But, this configuration of free banking was not the one that most fully attained the goal Mises set for the ideal monetary system. The configuration that removed government most fully from monetary affairs and, thereby, restricted monetary inflation and credit expansion to the greatest degree begins with "the idea implied in the Currency Theory," Mises (1998, p. 439) wrote, "that all banks be forced by law to keep against the total amount of money-substitutes . . . a 100 per cent money reserve"[19] and then grounds money in gold and free banking in contract law. Mises wrote:

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[18]Selgin (2000, p. 93) agrees that money proper should be gold. White (1985, pp. 124-26), on the other hand, is ambiguous on this point.

[19]Mises also points out that the Peel Act of 1844 was defective because it did not go far enough in restraining inflationary forces:

> On the one hand, the system of government interference with banking was preserved. On the other hand, limits were placed only on the issuance of banknotes not covered by specie. The fiduciary media were suppressed only in the shape of banknotes. They could thrive as deposit currency. (Mises 1998, p. 439)

Also, on Mises's view of the Currency School, see Salerno (1993, pp. 141-42). White (1992, p. 524) has a different assessment of Mises's views on the Currency School.

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> But even if the 100 per cent reserve plan were to be adopted on the basis of the unadulterated gold standard, it would not entirely remove the drawbacks inherent in every kind of government interference with banking. What is needed to prevent any further credit expansion is to place the banking business under the general rules of commercial and civil laws compelling every individual and firm to fulfill all obligations in full compliance with the terms of the contract. (1998, p. 440)

Free banking is one component of this monetary system. But the best system of free banking, Mises argued, is the one that has a prohibition on the issue of additional fiduciary media and thereby restricts additional money-substitutes to money-certificates. Mises conceded that while free banking with fractional reserves does permit credit expansion, and thus does not fully attain his goal, it would have been better historically than the system of government intervention which gave special legal privileges to banks, for example, suspension of specie redemption. Mises wrote:

> Free banking is the only method available for the prevention of the dangers inherent in credit expansion. It would, it is true, not hinder a slow credit expansion, kept within very narrow limits, on the part of cautious banks which provide the public with all information required about their financial status. But under free banking it would have been impossible for credit expansion with all its inevitable consequences to have developed into a regular–one is tempted to say normal–feature of the economic system. Only free banking would have rendered the market economy secure against crises and depressions. (1998, p. 440)[20]

But however history may have played out in the absence of government privileges given to banks, this possibility was no longer present in 1949. The market economy had experienced crises and depressions, and Mises proposed the monetary reform that restricted credit expansion most severely. He feared that any halfway measures, in any of the three features of the most-restrictive monetary system, would still leave room for government to regain its control and resume its inflationary ways. He wrote:

> If banks are preserved as privileged establishments subject to special legislative provisions, the tool remains that governments can use for fiscal purposes. Then every restriction imposed upon the issuance of fiduciary media depends upon the government's and the parliament's good intentions. They may limit the issuance for periods which are called normal. The restriction will be withdrawn whenever a government deems that an emergency justifies resorting to extraordinary measures. If an administration and the party backing it want to increase expenditure without jeopardizing their popularity through the imposition of higher taxes, they will always be ready to call their impasse an emergency. Recourse to the printing press and to the obsequiousness of bank managers, willing to oblige

[20]In contrast, Selgin and White (1996, p. 103) claim that in this passage Mises is making a theoretical claim about this type of free banking.

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> the authorities regulating their conduct of affairs, is the foremost means of governments eager to spend money for purposes for which the taxpayers are not ready to pay higher taxes. (Mises 1998, p. 440)

Monetary Reform: The Gold Standard and 100-Percent-Reserve Banking

Mises's concern with the changing historical conditions pushing ever harder for credit expansion was only one factor that led him to eventually adopt the view that banks should be prevented from issuing any new fiduciary media; thereby, cutting off the fuel for the boom-bust cycle. Salerno (1993, p. 139) has pointed out "significant developments in Mises's theory of money...occurred between the publication of the first German edition of *The Theory of Money and Credit* in 1912 and the publication of *Nationalökonomie* (the German language forerunner of *Human Action*) in 1940." As Salerno (1993, pp. 139 and 143) notes, Mises himself acknowledged that his monetary theory achieved completion only with the publication of his *magnum opus*, and that when his thought on "entrepreneurship, monetary calculation, and money" developed fully, Mises downgraded his former assessment of the benefits of issuing fiduciary media, especially the harm of increases in money's purchasing power, and upgraded his assessments of its drawbacks, especially credit expansion.

Mises advanced his proposal for a monetary system with zero credit expansion, that is, a gold standard with no issue of fiduciary media, as part of his program for monetary reform as early as 1944, and he repeated it in his 1952 essay on monetary reconstruction.[21] He wrote:

> The main thing is that the government should no longer be in a position to increase the quantity of money in circulation and the amount of checkbook money not fully–that is, 100 percent–covered by deposits paid in by the public. No backdoor must be left open where inflation can slip in. (Mises 1980, p. 481)

When applied to the United States, monetary reform must include restoration of the public's right to redeem the dollar for gold. "To enable the Conversion Agency to [buy gold against dollars at the legal parity]," Mises (1980, p. 492) wrote, "it is to be entitled to issue dollar bills against a 100-percent reserve in gold." Banks can only issue checkable deposits that are 100-percent backed and, therefore, can issue no additional fiduciary media. "This means a rigid 100-percent reserve for all future deposits," Mises (1980, p. 491) wrote. Barred from issuing additional fiduciary media, banks could play no role in generating a boom-bust cycle, even if they had existing fiduciary media outstanding. With the government impetus for inflation removed from the

[21]The 1944 essay is included in a volume of Mises's previously unpublished manuscripts (Ebeling, ed., 2000). The 1952 essay was made an addendum to the 1953 edition of *The Theory of Money and Credit.*

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monetary system and 100 percent reserve banking, inflation, the main enemy in monetary affairs, is at last restricted as much as possible.

As noted above, Mises thought that if left to the free choice of the market, a parallel standard would emerge. But government intervention had given the world the gold standard, which in turn became the money of the world economy transcending the governments that created it. Given the historical reality of the gold standard, Mises (1998, p. 445) argued that monetary reform could not immediately throw the choice of money open to the market again, but must establish the ideal monetary system, that is, the one that permits no credit expansion, by reforming the existing monetary system.[22]

The reform measure of restoring dollar redemption for gold reestablished the actual historical metallic standard and thereby cut off the inflationary impulse acting on the stock of money. The 100-percent-reserve requirement cut off the inflationary impulse acting on money substitutes. The reason Mises (1998, p. 431) wanted to restrict only additional fiduciary media and not eliminate them all was the possibility of an artificial, and thus harmful, deflation from immediate retirement of all existing fiduciary media and his view that existing fiduciary media have already had their effects on the market economy and thus could not be a source of further credit expansion.[23]

It was the historical experience of the booms and busts and the propaganda that they were part and parcel of the market economy that did the most to discredit capitalism. Mises wrote:

> Looking backward upon the history of the last hundred years, one cannot help realizing that the blunders committed by liberalism in handling the problems of banking were a deadly blow to the market economy. . . . Nothing harmed the cause of liberalism more than the almost regular return of feverish booms and of the dramatic breakdown of bull markets followed by lingering slumps. Public opinion has become convinced that such happenings are inevitable in the unhampered market economy. People did not conceive that what they lamented was the necessary outcome of policies directed toward a lowering of the rate of interest by means of credit expansion. They stubbornly kept to these policies and tried in vain to fight their undesired consequences by more and more government interference. (1998, pp. 440-41)

It was of the utmost importance, for Mises, to set the record straight on this point and to inoculate the market economy from the boom-bust cycle by purging money and banking of their interventionist elements. In making his

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[22]On Mises's ideal monetary system being one without credit expansion, see Salerno (1993, pp. 139-42).

[23]Although both Selgin and White are eager to put distance between Mises's views on money and banking and those of Murray Rothbard, Mises's monetary reform has many affinities with that advocated by Rothbard. See Selgin (1999, p. 259) and White (1992, pp. 517-18). See Rothbard (1990, 1991, 1994) on a free market monetary system and monetary reform.

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case for the gold standard and 100-percent-reserve banking, Mises was making his case for the market economy and, in so doing, striving to rescue Western civilization from its slide into socialism.

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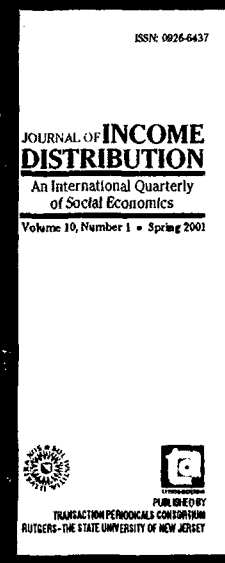
ISSN: 0926-6437
JOURNAL OF INCOME DISTRIBUTION
An International Quarterly of Social Economics
Volume 10, Number 1 • Spring 2001
PUBLISHED BY
TRANSACTION PERIODICALS CONSORTIUM
RUTGERS-THE STATE UNIVERSITY OF NEW JERSEY

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ISSN: 0926-6437

Published Quarterly

Subscription Rates:
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HAYEK'S LIBERALISM AND ITS ORIGINS: HIS IDEA OF SPONTANEOUS ORDER AND THE SCOTTISH ENLIGHTENMENT. CHRISTINIA PETSOULAS. LONDON: ROUTLEDGE STUDIES IN SOCIAL AND POLITICAL THOUGHT. 2001.

Hayek points to the works of Bernard Mandeville, David Hume, and Adam Smith as the primary origins of his social theory of spontaneous order. Christinia Petsoulas critically examines that claim and concludes, not simply that Hayek is too modest in understating the originality of his own thought, but that "a convincing critique of the main tenets of cultural evolution can be provided by the very thinkers whom Hayek cites as intellectual forefathers."

Two opening chapters give an excellent account of Hayek's social theory and of the limits to reason. It is argued that Hayek fails to give explicit acknowledgement to the deployment of "two types of evolutionary explanation": the invisible-hand market order (dispersed knowledge is utilized to greatest effect); and a process of group selection (an institutional framework of social rules evolves in such a manner that "inefficient practices are eliminated"). Beyond that, Hayek's contention—"that human conduct is ultimately governed by abstract rules that cannot be articulated"—is challenged.

Three chapters deal respectively with Mandeville, Hume, and Smith. The author finds no evidence in their writings of Hayek's "twin ideas of evolution and spontaneous order." Rather, the common element rests between the "two extremes" of spontaneous and constructivist order: a thesis that "Hayek seems to ignore" in "his eagerness to discredit . . . social engineering." The common element is "a theory of *trial and error* which is governed by *intentional* experimentation"; and so "Mandeville's political economy indicates that economic co-ordination is not brought about spontaneously but involves a fair degree of interventionism"; and "both Hume and Smith attribute the selection of rules to individual intentionality and understanding of their benefits."

The author accepts that "customs and conventions can in principle be expected to arise spontaneously." Though plausible for mechanistic applications "like playing the piano or riding a bicycle," the notion of subconscious rule-following is "much less convincing" in respect of man's sense of justice. The argument is that, because "rules of justice constitute solutions to 'collective action problems,' they require collective agreement"; and that the latter requires "a degree of individual foresight and intentionality, both of which are precluded in Hayek's theory of cultural evolution." How,

THE QUARTERLY JOURNAL OF AUSTRIAN ECONOMICS VOL. 5, NO. 1 (SPRING 2002): 93-95

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for example, would it be possible for judges to "decipher rules of whose existence and function they are as unaware as anyone else and which they follow no less unconsciously than the other members of society?" Good question; but this *is* the difficulty that denies an overaching legal oracle and insists upon cautious evolutionary development. Common law evolves as parties fail to reach mutual agreement and seek impartial judgment. Thereby rules of justice emerge so that–while intentionality and *attempts* at foresight are ever present–the common law is plausibly described as contributing to a spontaneous order.

In general regard to subconscious rule-following, the author expects too much of Hayek. It is a truism, not a criticism, that the existence of "meta-conscious rules is postulated rather than demonstrated." It is *always* the case that "the investigation of consciousness (and all other cognitive phenomena) is condemned to some indirectness" (Damasio 1999, p. 81).

The author draws a distinction between spontaneous order and order based upon consensus: "[i]f prior acceptance of the unpalatable consequences of the market order is a condition for its existence, it can hardly be claimed that the market order is *spontaneous*." Certainly, but, if "prior" is deleted, spontaneity and consensus are not mutually exclusive categorizations. Surely, consensus can emerge as agencies reach successive adaptive compromises (both tacit and explicit). The author also asks how social rules of general benefit arise in circumstances where individual advantage and group advantage are opposed: "a behavioral rule bringing about universal cooperation cannot be expected to emerge spontaneously by means of an individualistic process." Why not? In dynamic game theory (which the author invokes), the prisoners' dilemma (PD) fades with the evolution of strategic counterplay, but this possibility is rejected for "modern market society" where unilateral defection is unlikely to be discovered. It is asserted that in: "a large and impersonal social setting . . . a powerful organization is required to enforce PD norms. This organisation is the state." Of course, many social rules require authoritative support but, without a general acceptance of the justice inherent in such rules, history shows that enforcement throws crippling burdens upon the state.

The author believes that the necessity for "external mechanisms of rule enforcement" implies "that emphasis be placed on rational foresight and intentionality in first identifying and subsequently implementing 'appropriate' group beneficial rules." Emphasis is the nub. Hayek saw the relevance of rules that are both spontaneous and constructivist in origin: "before we can hope successfully to improve them, we must learn to comprehend much better than we do now in what manner the man-made rules and the spontaneous forces of society interact" (1967, p. 92). Yet, Hayek's emphasis is that spontaneous evolutionary developments generally incorporate levels of understanding that surpass those that support a constructivist rational approach. In presenting Hayek as an spontaneous order extremist, who is prone to the inconsistency of invoking "man-made rules," a target for easy criticism is created. This is a caricature.

The real Hayek is driven by an ideology that attempts to "marry a Kantian view of justice as an institution concerned with the distribution of freedom, with a Humean view of justice as an institution preserving order among men" (Kukathas 1989, p. 205). He sees himself as a liberal in the classical tradition. That liberalism is not a consequence of, but a prerequisite for, spontaneous order. Certainly, Hayek believes that liberalism requires protection. It needs support for the diversity of lifestyles that is tolerated and for allowing individuals and diverse groupings to challenge conventional

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practices. Tautologically, if moral acts are those that augment social cohesion, then morality is established by whichever code of social conduct allows the group to survive. Yet, all adaptations "have one potentially grave drawback: they are constructed on the basis of instructions built up in the past" (Plotkin 1994, p. 153). Since adaptation is necessarily to events previously encountered, successful adaptation offers no guarantee against novel predicaments. There are no means to determine whether an institutional adaptation is likely to enhance or to jeopardize survival prospects. For nonrecurrent changes, a special class of adaptation is required–intelligence–that allows an organism to cope with future circumstances which are unlike those of the past. Hayek does not denigrate intelligence; he simply points to a tendency to overrate intelligence.

Hayek researched the features of an extensive political economy, with explicit consideration of the psychological limits to human understanding, the market as an information-gathering process and its relationship with the free society, where moral and political issues are understood within a framework of continuous adaptation. Is it not the case that political liberalism secures the diversity that raises the likelihood of successful adaptation, both of individual agencies within groups and for rivalry between groups? Hayek's general tenet is that moral values are grounded in cultural evolution; that "the ultimate decision about what is good or bad will be made by the evolutionary de-selection of groups that adhere to 'wrong' beliefs." Is the implication (as drawn by the author) that Hayek thereby "removed the possibility of defending liberty on moral considerations?"

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PROPERTY AND FREEDOM: THE STORY OF HOW THROUGH THE CENTURIES PRIVATE OWNERSHIP HAS PROMOTED LIBERTY AND THE RULE OF LAW. RICHARD PIPES. NEW YORK: KNOPF. 2000.

Every once in a while a book comes along which bodes well to explain, expound upon, and, most important, defend and justify that much-maligned institution private property rights but which turns out, in the end, to be a disappointment. Two years ago it was Bethell's *The Noblest Triumph* (1998)[1] that took on this role. This time around it would appear to be the turn of Pipes's *Property and Freedom* that fails to meet our hopes and expectations.

Although I have come to "bury, not praise" this book for its deviations from the philosophy of private property that it ostensibly defends, I must start out on a positive note, because, however flawed, Pipes does make a contribution to our appreciation for private property. It cannot be denied that the book starts out on a high plain. Certainly, Pipes is correct in locating the difficulties suffered by both Russia and later the U.S.S.R. in terms of the lack of appreciation for private property endemic in that society. And what could be more uplifting than to be told, with clarity and passion, that property rights promote stability, constrain the powers of government, enable people to capture the fruits of their own labor, enhance economic efficiency, and promote individuals' sense of self-worth (p. 4)? Also to be admired is his careful exegesis of the views on property by such philosophers as Plato, Aristotle, Ovid, Augustine, Aquinas, More, Spinoza, Bodin, Grotius, Seneca, Hobbes, Locke, Hume, Rousseau, Proudhon, Marx, Engels, Mill, Boas, Rawls, Fromm, Condorcet, and many more. This is a *tour de force* of the history of the philosophy of property rights.

Nor is this book at all behindhand in stressing the importance of possessiveness—on the part of animals, children, primitive peoples, hunters and gatherers, in antiquity, under feudalism, in medieval days—in accounting for the range and depth of property in human civilization. His history of property in England is alone more than worth the price of admission.

The author wishes to thank Ilana Mercer for comments.

[1]Pipes (p. 286) is a supporter of the Bethell book, stating that the latter has "convincingly presented . . . the close relationship between property and prosperity." For a critique of this book see Block (1998).

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As a historian of property, throughout the centuries and all around the world, Pipes is exemplary. And this goes, in spades, for his criticism of how property is treated under both communism and fascism. It is only his economic and political understanding of the concept–particularly in regard to the welfare state–with which I wish to quarrel.

Here, Pipes's treatment can only be considered problematic. Consider his views on the New Deal in general, and, such measures as the Social Security Act of 1935 and the Fair Labor Standards Act of 1938: "These measures belatedly guaranteed Americans the kind of social benefits that the Germans and English had taken for granted for decades. They were certainly needed" (p. 241). This is neither the time nor the place for a full-scale critique of the New Deal; suffice it at this point to state that these legislative initiatives were, if anything, the very antithesis of private property rights.

Or consider this statement:

> The symbiotic relationship between property and freedom does not preclude the state from imposing reasonable restraints on the uses made of objects owned, or ensuring the basic living standards of the neediest strata of the population. Clearly, one cannot allow property rights to serve as a license for . . . ignoring the fundamental needs of the unemployed, sick, and aged. Hardly anyone contests this proposition today: even Frederick (sic) Hayek, an implacable foe of state intervention in the economy, agreed that the state has the duty to ensure for all citizens "a minimum of food, shelter and clothing, sufficient to preserve health and the capacity to work." (p. 287)

Pipes cites Hayek's *Road to Serfdom* in this regard. But there are difficulties here. First and foremost, the Pipes book is presumably one in *favor* of private property rights. How can this possibly be squared with the forced taking of the wealth of some citizens, in order to give it to others? Would not private charity be a way of helping the poor far more in keeping with the presumed goal of this book? (Olasky 1991, pp. 3-24; Hughes 1990, pp. 43-56). Second, Pipes employs the argument from authority, an informal fallacy in logic. "Even . . . Hayek says" this is not a coherent argument; it is the substitute for such. And third, it is simply not true that Hayek is "an implacable foe of state intervention in the economy," no matter how widespread is this fallacious rumor. Very much to the contrary, he makes room for all sorts of government interventions and violations of property rights (Block 1996, pp. 327-50).

Perhaps realizing something of the intellectual quagmire into which he has just jumped, Pipes attempts to pull back from the precipice with the following:

> But to say this is not to grant the state the authority to use the powers at its disposal to interfere with the freedom of contract, to redistribute wealth, or to compel one part of the population to bear the cost of the self-defined "rights" of special constituencies. Limitations on the use of property imposed for public good should surely be interpreted as "takings" and adequately compensated. (p. 287)

But like the tar baby, this only gets him deeper into the pit.

Pipes has just finished, à la Hayek, justifying the welfare system.[2] He now contradicts himself by asserting that "this is not to grant the state the authority . . . to redistribute wealth." What else but a wealth redistribution scheme does this author think the welfare system is? Welfare, further, is the very paradigm case of compelling

[2]For a devastating critique, see Rothbard (1984).

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"one part of the population to bear the cost of the self-defined 'rights' of special constituencies." In this case, the special constituency are the poor. And as for "rights," Pipes it is not clear what "printing press rights" means and "class rights," even going so far as to cite libertarians Ayn Rand and Henri Lepage to this effect (pp. 288-89). The point is, there is simply no such thing as a "right" to the wealth of other people, the premise underlying the forced transfer of income from the rest of the population to the poverty stricken.[3] It is one thing to contradict oneself in a large book in widely dispersed sections of it, or in other writings, but here the inconsistency appears on the very same and contiguous pages. Nor will compensation for "takings" avail this author much in the way of mitigation.

First, a "taking" is the equivalent of theft, surely incompatible with a regime of private property rights. Second, if they are "adequately compensated," what is the *point* of stealing? Surely, adequate compensation in this context implies that which the *robber* determines it to be. Were it to satisfy the property owner, there would be no reason for the "taking" in the first place; an ordinary purchase would suffice. Suppose you own a car, and I "take" it from you, offering compensation of $10, which I deem adequate. This is indistinguishable from a theft of the value of the automobile minus the $10. On the other hand, suppose you place a value of slightly less than $10,000 on your vehicle, and I "take" it, while giving you precisely $10,000. Then, there is no difference between this and an ordinary purchase. Pipes cannot be allowed to have it both ways: either compensation for a "taking" is adequate in the mind of the original owner, in which it is not a taking, or it is inadequate in his view, in which case it is downright theft.

And what is with this "public good" business? Surely, if there is anything such as the "public good," a dubious proposal on its face, it consists of nothing more and nothing less than the *protection* of property rights (to persons as well as physical objects), not the denigration of them as urged by Pipes with his advocacy of welfare-state socialism. Pipes explicitly rejects "group rights rather than individual rights," but is not the right to welfare a "group right" (p. 289)?

Pipes's view of the relationship between democracy and coercion is also somewhat suspect. He approvingly cites Hayek to the effect that "the functions of the State (should be) limited to fields where real agreement among a majority could be achieved" (p. 291). He then goes on to declaim: "This reasoning explains why government interference in the life of the citizenry even for benevolent purposes endangers liberty: it posits a consensus which does not exist and hence requires coercion." But the implication of this is that if but majority consensus *could* be achieved, why, then, state action would *not* be coercive, and nothing could be further from the truth. For take a case where a democratically elected government, we stipulate *arguendo*, pursued policies that were popular with the majority: the Nazi persecution of the Jews. Were he to carry forth on the logic of his own premises, Pipes would have to deny that the Holocaust was coercive, since "real agreement among a majority [was] achieved" here; a consensus on this policy *did* exist. The point is, there can be such

[3]Pipes cannot plead ignorance of the distinction between the legitimate "negative" rights not to be molested or victimized by theft, on the one hand, and the so-called "positive" rights to food, clothing, and shelter at other people's expense, as he discusses these, correctly on pages 245-47 (for more on this see Rothbard 1998). Pipes understands this, full well, in "theory," but is unable or unwilling to apply these insights to the welfare state.

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a thing as the tyranny of the majority. Democracy is hardly a guarantee of the respect for private property rights in persons and things.

Nor need we accept Pipes's contention that the welfare system evidences "benevolent purposes." Suppose five robbers break into the home of a family of four. As the robbers are about to leave with the owners' possessions, the owners object, on the grounds of private property rights. The criminals, being of a philosophical bent, are willing to engage in dialogue with their victims. Under the influence of Pipes, they are willing to hold a democratic referendum on the issue of whether or not it is justified for them to "take" the family's household goods. The vote proves conclusive: five in favor (the thieves) and four against (the family members.) Would it make any difference if thereupon the gang stated that it was their intention to distribute their ill-gotten gains to the poor, and thus their motives were "benevolent"? Not at all. Theft is theft, and there need be no benevolence to it at all.

Let us end on a sad note for Pipes's comprehension of the doctrine of private property rights. I quote him in full on this, one, so that there be no possible misunderstanding, and two, the better to ferret out his errors and expose them. He states:

> The government is not the only entity restricting property rights to real estate. Guilty also are private associations of homeowners which arrogate to themselves quasi-governmental functions. Such associations, set up by developers to administer condominia, cooperative apartments, and single-family planned units, have grown from fewer than 500 in 1964 to 150,000 in 1992; their rules and regulations affect an estimated 32 million people. The objective of these associations is to protect property *values* of a community by imposing strict guidelines concerning the appearance and use of real estate. Paradoxically, by protecting the values of the community's housing they infringe on the property *rights* of owners. Many of the restrictions are proper and sensible. But some communities go to extremes: they may forbid the growing of vegetables or the installation of air conditioners, limit visits by grandchildren, regulate the color of curtains, prohibit the home delivery of newspapers or the display of the American flag, etc., etc. Failure to abide by the community's rules and regulations can lead to the imposition of fines. Although in theory membership in such regulated communities is voluntary, many families have no choice but to buy into them because of price, location, or some other compelling factor. And once they do so, they lose a great deal of freedom and even privacy. (p. 253)

It is hard to know where to begin, there are so many mischievous errors packed into so small a space.[4] The core fallacy is that ownership of property under such restrictive covenants is somehow coercive, as if people are forced against their will into making condominium purchases. If a man can be "compelled" to buy a co-op apartment because of "price or location," then there is no hope for any of us, since the same can be said of *every* possible purchase of *anything*. That is, everything that anyone takes into ownership through commercial means has some sort of price and is located somewhere or other. We must conclude that this consideration, contrary to Pipes, is entirely insufficient to establish coercion. Further, it matters not one whit what specific rules are imposed upon owners; as long as they agree to them, and are not initially misled through fraud, there is no violation of property rights. It doesn't

[4]For another statement along these lines, see Holcombe 1994. For a rebuttal, see Block forthcoming.

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matter if I agree to do something truly demeaning; for example, push a peanut with my nose down the street, wearing a propeller beanie. As long as I *consent* to be bound by such rules, there is nothing amiss, as far as private property is concerned.[5] Nor can we accept Pipes's distinction between "sensible infringements" upon rights, and those which "go to extremes." One man's extreme is another's moderation. In the event, all such contracts must necessarily be mutually beneficial in the *ex ante* sense. Were they not expected to generate benefits, they would hardly be entered into in the first place. Based on the statistics supplied by Pipes himself, they must be very successful, too, in the *ex post* sense.

In conclusion, while this author does support private property rights, his analysis is vitiated somewhat by a welter of mistakes and confusions. Perhaps a better title for the book would have been *One Cheer for Private Property Rights.*

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[5]Under voluntary sadomasochism, people assent to being whipped. Should such a person be allowed to accuse the sadist of assault and battery? No more than should one boxer be allowed to sue another for punching him. When you enter the boxing ring, you *agree* to being hit (above the belt). Under Pipes's dispensation, there could be no such contracts–a violation of liberty if ever there was one.

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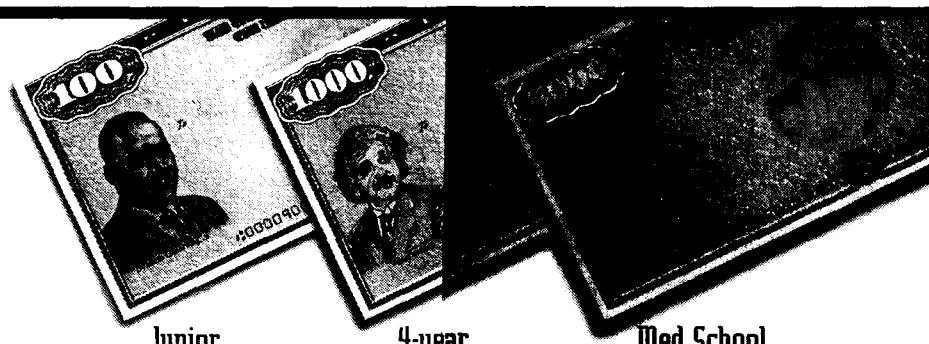

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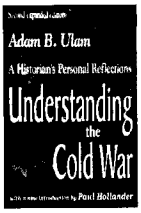

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